

# **TRANSCRIPT OF RECORD.**

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**SUPREME COURT OF THE UNITED STATES.**

**OCTOBER TERM, 1921.**

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**No. 416.**

**JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE  
FOR THE DISTRICT OF MARYLAND, PLAINTIFF IN  
ERROR,**

**vs.**

**THE SAFE DEPOSIT AND TRUST COMPANY OF  
BALTIMORE, GUARDIAN OF FRANK R. BROWN.**

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**IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF MARYLAND.**

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**FILED JULY 12, 1921.**

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PLAINTIFF IN ERROR,

vs.

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MORE, GUARDIAN OF FRANK R. BROWN.

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1 UNITED STATES OF AMERICA,  
*District of Maryland, to wit:*

At a District Court of the United States for the District of Maryland, begun and held at the city of Baltimore on the first Tuesday in March (being the first day of the same month) in the year of our Lord one thousand nine hundred and twenty-one.

Present: The honorable John C. Rose, judge, Maryland District; Robert R. Carman, Esq., attorney; William W. Stockham, Esq., marshal; Arthur L. Spamer, clerk.

Among other were the following proceedings, to wit:

SAFE DEPOSIT AND TRUST COMPANY, OF BALTIMORE,  
 guardian of Frank R. Brown,

vs.,

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE  
 for the District of Maryland.

No. 947. Law.

2 DECLARATION.

*Filed 6th November, 1920.*

In the District Court of the United States for the District of Maryland, at law.

BALTIMORE CITY, TO WIT:

The Safe Deposit and Trust Company of Baltimore, a corporation organized and existing under the laws of the State of Maryland, guardian of Frank R. Brown, an infant under the age of twenty-one years, by Arthur W. Machen, jr., its attorney, sues Joshua W. Miles, United States collector of internal revenue for the District of Maryland.

FIRST COUNT.

(1) For that the plaintiff is a corporation formed under the laws of the State of Maryland and duly authorized to act as guardian or other fiduciary, and being so authorized was heretofore, to wit, on the 30th day of January, 1919, duly appointed by the Orphan's Court of Baltimore City guardian of Frank R. Brown, an infant of tender years. Said Frank R. Brown is a citizen of the United States and resident of Baltimore city, in the State of Maryland. Frank S. R. Brown was the father of said Frank R. Brown, and departed this life intestate on January 16, 1918, leaving surviving him a widow and said Frank R. Brown, infant, and no other children or descendants. Among the assets of the estate of Frank S. R. Brown, deceased, were thirty-five (35) shares of the capital stock of the Hartford Fire Insurance Company, which is a body corporate incorporated under the laws of the State of Connecticut, having a capital stock of twenty thousand (20,000) shares of a par value of

\$100 per share. In the year 1919, to wit, on February 1st, the estate of said Frank R. Brown, deceased, was settled by his administrator and said thirty-five (35) shares of stock in the Hartford Fire Insurance Company distributed to the plaintiff, as guardian of said Frank R. Brown, infant. Subsequently, in the year 1919, the said Hartford Fire Insurance Company pursuant to the laws of the State of Connecticut increased its capital stock from twenty thousand (20,000) shares of the nominal or par value of \$100 each to forty thousand (40,000) shares of the nominal or par value of \$100 each, and, as required by law to do, accorded to its old stockholders the right of subscribing pro rata to their quota of the new or increased stock at \$150 per share, in order to preserve their proportionate interest in the company. The plaintiff, as guardian of said

3 Frank R. Brown, infant, accordingly became entitled to subscribe to thirty-five (35) new or additional shares of said stock. This right to subscribe to said new or additional shares the plaintiff, pursuant to an order of the Orphan's Court of Baltimore City, sold for \$12,456.80, on the 19th day of July, 1919. The stock of the Hartford Fire Insurance Company at the date of the death of the said Frank S. R. Brown, to wit, on January 16, 1918, was quoted at \$680.00 per share bid and \$700 per share asked. At the time of the passage of the administration account and the settlement of the said estate by the distribution of said thirty-five (35) shares of stock in the Hartford Fire Insurance Company to the plaintiff, as guardian of Frank R. Brown, said stock was quoted at \$705 per share bid and \$720 per share asked. Said stock was appraised by the appraisers of the Orphans' Court of Baltimore City at \$650 per share and returned by the administrator of Frank S. R. Brown, deceased, in the inventory filed in the Orphans' Court of Baltimore City, at said last-mentioned price. After the increase of stock by the Hartford Fire Insurance Company as aforesaid, the stock of said company was quoted on the market at \$510 per share bid.

The defendant is an inhabitant of Maryland and is the United States collector of internal revenue for the District of Maryland, duly appointed by the President and confirmed by the Senate. Heretofore, to wit, on July 1st, 1920, the said defendant, being such collector and having notice of all the facts hereinabove set forth, demanded from the plaintiff as guardian of Frank R. Brown, infant, the sum of \$1,130.77 as income tax for the calendar year 1919, on the theory that the whole proceeds of the sale by the plaintiff of the right of his ward to subscribe to new or additional shares of the capital stock of the Hartford Fire Insurance Company for the purpose of preserving his proportionate interest in said company, constituted income which is taxable under the sixteenth amendment to the Constitution of the United States and the acts of Congress passed pursuant thereto, particularly the act approved February 24, 1919; but the plaintiff says that the said proceeds of sale are the sale of a portion of the original capital of the estate represented by the plaintiff, and that being capital as aforesaid the same

4 are not liable to tax under the sixteenth amendment to the Constitution of the United States, and are, therefore, only taxable directly by the Federal Government through a tax apportioned between the States on the basis of population, and that if said act of Congress should be construed to tax said proceeds of sale as income, the same is not warranted by the sixteenth amendment to the Constitution of the United States according to the true construction thereof, and is therefore unconstitutional, null, and void. But, although the defendant had notice of all the facts aforesaid, he persisted in his demand that the whole of said proceeds of sale should be treated as taxable income of the estate of Frank R. Brown, infant, for the year 1919, and the plaintiff, in order to avoid the penalties threatened by the defendant and the liability of its property to distraint, paid to the defendant, under protest, the amount demanded, namely, \$1,130.77. Whereupon the plaintiff appealed to the Commissioner of Internal Revenue to reverse the action of the defendant in the premises and to refund to the plaintiff the amount of said tax so illegally and unconstitutionally levied and collected from the plaintiff, but the said Commissioner of Internal Revenue heretofore, to wit, on October 30, 1920, refused to refund to the plaintiff the whole or any part of said sum so illegally and unconstitutionally collected from the plaintiff, whereupon the defendant became indebted to the plaintiff in the amount so illegally and unconstitutionally collected, with interest, and being so indebted promised to pay the same, but has not paid the same or any part thereof. Whereupon the plaintiff brings this suit.

## SECOND COUNT.

(2) For money payable to the plaintiff, a corporation incorporated under the laws of Maryland, by the defendant, who is an inhabitant of Maryland and who, at the time of the transactions hereinafter stated, was and ever since has continued to be and now is United States collector for the District of Maryland, duly appointed by the President and confirmed by the Senate, for money had and received by the defendant to the plaintiff's use, being money which was illegally extorted by the defendant from the plaintiff under color of the act of Congress levying an income tax for the year 1919, 5 and which the plaintiff paid under protest in order to relieve its property from distraint, first calling the defendant's attention to the facts and circumstances rendering the said demand illegal, and which the Commissioner of Internal Revenue, on appeal duly made to him by the plaintiff from the said illegal action of the defendant, has refused to refund or to order refunded; and the plaintiff says that the defendant in demanding said money from the plaintiff treated as income money which was really capital, and that if the act of Congress should be construed as authorizing the levy of a tax thereon the said Act would not be warranted by the sixteenth amendment to the Constitution of the United States and would be in conflict

with the said constitution and null and void, because amounting to the levying of a direct tax on capital without apportionment between the States on the basis of population.

### THIRD COUNT.

For that the plaintiff is a corporation formed under the laws of the State of Maryland and duly authorized to act as guardian, and being so authorized heretofore, to wit, on January 30, 1919, was duly appointed guardian of Frank R. Brown, an infant of tender years, by the Orphans' Court of Baltimore City; and that the defendant is an inhabitant of the judicial district of Maryland and is United States collector of internal revenue for the District of Maryland, duly appointed by the President and confirmed by the Senate; and that heretofore, to wit, during the year 1919, a large sum of money, to wit, the sum of \$12,546.80, constituting capital of the estate of the plaintiff's said ward, came into the hands of the plaintiff as guardian as aforesaid, and subsequently, to wit, in the year 1920, the defendant asserted that said sum so constituting capital as aforesaid constituted income, taxable as such under the act of Congress imposing a tax on incomes for the calendar year 1919. Thereupon the plaintiff protested against said claim and demand of the defendant and fully informed the defendant of the fact that such moneys so constituted capital and not income, but nevertheless the said defendant insisted that the same constituted income and demanded from the plaintiff a

large sum of money as Federal income tax thereon for the year 1919, to wit, the sum of \$1,130.77, and threatened to collect said tax by distraint upon the plaintiff's property, and also to impose certain penalties for nonpayment thereof if the same should not be paid. Whereupon the plaintiff, in order to avoid said threatened penalties and to relieve its property from said threatened distraint heretofore, to wit, on July 9, 1920, paid the said sum so demanded to the defendant under protest, notifying him of the illegality of his said demand and of the intention of the plaintiff to sue for the recovery of the money so paid if the same should not be refunded. The defendant persisted in holding said money and thereupon the plaintiff appealed to the Commissioner of Internal Revenue from the decision and action of the defendant as aforesaid, and prayed the said commissioner to refund the said amount to the plaintiff, but the said commissioner refused so to do and affirmed the action of the defendant in the premises. Wherefore the defendant became indebted to the plaintiff for the said sum of money so illegally exacted from the plaintiff, with interest from the time of payment, but the defendant has wholly failed and refused to pay the same or any part thereof. Wherefore the plaintiff brings suit for money payable by the defendant to the plaintiff for money had and received by the defendant to the use of the plaintiff.

And the plaintiff claims \$2,500 damages.

ARTHUR W. MACHEN, Jr.,  
*Attorney for plaintiff.*

## PLEAS.

*Filed 28th December, 1920.*

In the District Court of the United States for the District of Maryland.

SAFE DEPOSIT AND TRUST COMPANY OF BALTIMORE, A CORPORATION, etc., guardian of Frank R. Brown, etc.,  
*versus*  
JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE.

*Defendant's pleas.*

The defendant, Joshua W. Miles, collector of internal revenue, by Robert R. Carman, United States Attorney for the District of Maryland, for a plea to the declaration in the above-entitled case, and to each and every count thereof, says:

1. That he never promised as alleged.
2. That he never was indebted as alleged.

ROBERT R. CARMAN,  
*United States Attorney.*

Docket entry: 28 December, 1920. Issues joined.

## MEMORANDUM.

Whereupon and in pursuance of the agreement of counsel the issues joined as aforesaid between the parties aforesaid were tried before the court without a jury, the parties having agreed that this case should be tried by the court sitting without a jury, and the court having heard the evidence produced on behalf of the plaintiff and the defendant and considering the same and the prayers offered on behalf of the plaintiff and defendant and having made certain rulings thereon, doth say that the defendant doth owe to the Safe Deposit and Trust Company of Baltimore, guardian of Frank R. Brown, infant, the plaintiff in the above-entitled case, the sum of \$1,101.86, being a portion of the sum claimed in the declaration filed in said case.

And thereupon the court directed a verdict to be entered for the plaintiff for the sum of \$1,101.86 and the same was entered accordingly.

Therefore it is considered by the court here that the said plaintiff recover against the said defendant as well the said sum of \$1,101.86 for its damages as the sum of \$18.10 adjudged by the court here unto the said plaintiff for its costs and charges by it about their suit in this behalf expended; and the said defendant in mercy and that the said plaintiff have hereof its execution, etc.

## MEMORADUM.

Verdict was rendered in above-entitled case on the 26th day of May, 1921, and judgment on the 31st day of May, 1921.

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## OPINION OF THE COURT.

*Filed 26th May, 1921.*

In the United States District Court for the District of Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,  
guardian of Frank R. Brown,  
*vs.*

No. 947 Law.

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE.

*ROSE, District Judge:*

The plaintiff, the Safe Deposit and Trust Company of Baltimore, as guardian of one Frank R. Brown, an infant, sold for \$12,546.80 the right to subscribe for thirty-five shares of the stock of the Hartford Fire Insurance Company. The defendant, as collector of internal revenue, insisted that this entire sum was taxable income of the ward, and demanded \$1,130.77 as the tax thereon. The plaintiff paid it under protest, unabailingly appealed to the commissioner, and brought this suit. Its contention that what it received for the rights was capital, and not constitutionally taxable as income, has since been negatived by the Supreme Court. The *Merchants' Loan & Trust Co. vs. Smietanka*, decided March 28, 1921.

There remains for consideration its further claim that it is taxable upon such part only of the proceeds of the rights as was, in fact, gain or profit derived from the sale of or dealing in its property in the insurance company.

The Government, on the other hand, says that as the plaintiff paid nothing directly for the rights as such, all that it got from their sale was a clear profit to it.

The issue thus joined is whether the law will look to the transaction as a whole, or will close its eyes to everything that preceded the issue of the rights, and to all that came after their sale.

There is apparently only one case which has passed upon the precise question here raised. *Tax Commissioner vs. Putnam*, 227 Mass. 522. There the Government's position was squarely sustained, as was natural if not inevitable after court had held that stock dividends were taxable income, for while the returns from rights are different things and may be income, although such dividends are not, the reverse is scarcely possible.

If the stockholder must pay an income tax upon the full nominal amount of a stock dividend, he can hardly escape from paying upon all he gets from the sale of stock rights. It is impossible to be sure

that the Supreme Judicial Court would have held the latter taxable had it not first reached the conclusion that the former were. The express refusal of the Supreme Court of the United States to accept the ruling that stock dividends were not income necessarily deprives the Massachusetts case of persuasive force in the Federal courts. *Eisner vs. Macomber*, 252 U. S. 189-216. The question must therefore be dealt with as one upon which there is no direct authority. The reiterated declarations of the Supreme Court have, however, it is believed, made plain the principles which should govern its decision. What is taxable is the gain, profit, or income derived from the sale or dealing in property, whether real or personal. 39 Stat. 757; 40 Stat. 300-307; *Goodrich vs. Edwards*, decided March 28, 1921.

Congress, it is true, has very ample authority to adjust its income taxes according to its discretion, and the rules it prescribes for the ascertainment of taxable income are binding upon the courts unless they are palpably arbitrary and unjust. *LaBelle Iron Works vs. The United States*, decided May 16, 1921. The net revenue from some peculiar kind of property, such as mines, may include not only profit from operation, but a portion of the capital as well. The problems of apportionment may be too difficult and some of their factors too uncertain for adjustment by the courts, and the tax may have to be assessed upon the entire net proceeds with such deductions only, if any, as Congress may have authorized. *Von Baumbach vs. Sargent Land Co.*, 242 U. S., 503. Nevertheless by and large the statute means what it says, and that is that the tax is to be levied on nothing else except gains, profits, and income, and upon them only when actually realized in money or in money's worth, and in determining what is included therein the courts will look through form to substance. *Doyle vs. Mitchell Bros. Co.*, 247 U. S., 179; *Eisner vs. Macomber* (*supra*).

What are the facts to which these general rules are to be applied?

The shares of the Hartford Fire Insurance Company were worth on March 1, 1913, \$760 apiece. At the time of the death intestate of the ward's father the Government said that for the purpose of the estate tax they were each of the value of \$710, and that may be taken as their costs to the plaintiff. The insurance company determined to double the number of its shares and to give each of its stockholders the right, upon payment of \$150 a share, to obtain as many new shares as he held old.

The plaintiff in the right of every share it held and which had cost it, as just mentioned, \$710, could by paying \$150 a share more get another, so that it could have two, which in the aggregate would have cost it \$860, or \$430 apiece. There would be no way of distinguishing between the old and the new. If the latter was something which had not before existed, almost the same might as truthfully be said of the former. Its characteristics had undergone a great change. Before the issue of the new stock it represented one twenty-thousandth of the capital of the company; afterwards it stood for but one forth thousandth. Moreover, if the plaintiff had in



person taken the new stock and had had its old and new consolidated into one certificate and had subsequently sold a part of its holdings, it could not say that that with which it parted was out of the old or out of the new, or partly out of both. In determining its cost for the calculation of the profit or loss upon resale it would be necessary to assume that they had one and all cost the holder an equal amount, which in the case of the plaintiff here was \$430 a share.

It certainly could make no difference that without waiting until the stock was issued and then selling it sold the right to the new stock and made it part of the consideration that the buyer should assume for it the payment of the \$150 per share exacted by the company. All that would have to be borne in mind in comparing the two ways of reaching the same end is that if the right was sold the price really received for the new share was \$150 more than the sum paid to the seller, which in the case at bar was \$358.48. That was equivalent to \$508.48 for a fully paid for share, and the \$78.48 by which it exceeded the \$430 which the share costs the plaintiff was the gain or profit it made out of the transaction.

That is the whole story. If \$78.48 be multiplied by 35, the number of shares or rights sold by the plaintiff, the product will be \$2,746.80, and upon that it was properly taxable and upon nothing more.

13 It still retains 35 shares. When, if ever, they or any of them are sold there must be returned as profit in the year in which the price is received for them the amount, if any, by which that price exceeds \$430.

It is, of course, immaterial that if the plaintiff had chosen at the time it parted with the rights to the other thirty-five to sell any of those it still held, it would have made a taxable profit of nearly \$80 a share upon those so disposed of. There is no tax upon a profit until that profit is realized.

The counsel for the opposing parties can doubtless agree upon the figures for which, in accordance with the conclusions herein reached, the plaintiff is entitled to a verdict.

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CERTIFICATE OF PROBABLE CAUSE.

*Filed 4th June, 1921.*

In the United States District Court for the District of Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,  
guardian of Frank R. Brown,

vs.

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE.

No. 947. Law.

I, John C. Rose, judge of the District Court of the United States for the District of Maryland, on this 4th day of June, nineteen hundred and twenty-one, do hereby certify as follows:



That on the twenty-sixth day of May, nineteen hundred and twenty-one, in the above-entitled case, the court, sitting as a jury, found a verdict in favor of the plaintiff for \$1,101.86, and on said verdict final judgment was duly entered against the defendant, Joshua W. Miles, as collector of internal revenue.

That the suit wherein the verdict and judgment above stated was entered, was brought to recover the tax imposed, assessed, and collected under the provisions of the act of Congress of February 24, 1919, Revenue Act of 1918, Title 2, Income Tax, Part 1—Individuals (40 Stat. 1057), entitled "An act to provide revenue and for other purposes," upon all the proceeds, amounting to \$12,546.80, received by the Safe Deposit & Trust Company of Baltimore as guardian of Frank R. Brown, from the sale of certain rights to subscribe for thirty-five shares of stock of the Hartford Fire Insurance Company.

That the plaintiff, the Safe Deposit & Trust Company of Baltimore, as guardian of one Frank R. Brown, an infant, sold for \$12,546.80 the rights to subscribe for thirty-five shares of the stock of the Hartford Fire Insurance Company. The defendant, as collector of internal revenue, insisted that this entire sum was taxable income of the ward and demanded \$1,130.77 as tax thereon. The plaintiff paid it under protest and appealed without avail to the Commissioner of Internal Revenue, and thereafter brought suit to recover back the amount of tax so collected. The court found that

only a part of the sum so realized, or \$2,746.80, was properly taxable and that the amount of tax collected on the balance was erroneously collected.

That the acts done by the said defendant, Joshua W. Miles, collector of internal revenue, in imposing, assessing, exacting, and collecting the tax on all the proceeds of the sale of said rights to subscribe to thirty-five shares of stock of the Hartford Fire Insurance Company, which tax was paid under protest by the Safe Deposit & Trust Company of Baltimore, guardian of Frank R. Brown, were done in his official capacity, and that the said Joshua W. Miles had probable cause for his said acts, notwithstanding the tax collected on \$9,800.00 of the proceeds of the sale of the rights to subscribe for said shares of stock was erroneously collected and paid, and judgment entered therefor in this cause.

JOHN C. ROSE,  
*District Judge.*

*Filed 20th June, 1921.*

In the District Court of the United States for the District of  
Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,  
guardian of Frank R. Brown,

vs.

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE.

No. 947. Law.

*Bill of exceptions.*

At the trial of this case the defendant, Joshua W. Miles, collector of internal revenue for the District of Maryland, to support the issues on his part joined, produced testimony as follows.

It was mutually agreed between counsel for the respective parties in the above cause that the issues in this cause should be tried by the court sitting without a jury, and that the following facts should be taken as true with the same effect as if the facts were proved by competent evidence, that is to say:

*Stipulation.*

In the District Court of the United States for the District of  
Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,  
guardian of Frank R. Brown, infant,

vs.

JOSHUA W. MILES, COLLECTOR.

At Law.

It is mutually agreed that the issues joined in this case shall be tried by the court sitting without a jury, and that the following facts shall be taken as true with the same effect as if the facts were proved by competent evidence, that is to say:

The plaintiff is a corporation, formed under the laws of the State of Maryland and duly authorized to act as guardian or other fiduciary, and being so authorized was, on January 30, 1919, duly appointed by the Orphans' Court of Baltimore City guardian of Frank R. Brown, an infant of tender years. Said Frank R. Brown was and is a citizen of the United States and a resident of Baltimore City, in the State of Maryland. Frank S. R. Brown was the father of said Frank R. Brown, and departed this life, intestate, on

17 January 16, 1918, leaving surviving him a widow and the said Frank R. Brown, infant, and no other children or descendants. Among the assets of the estate of the said Frank S. R. Brown, de-

ceased, were 41 shares of the capital stock of the Hartford Fire Insurance Company, which had been acquired by said decedent prior to March 1, 1913.

The said Hartford Fire Insurance Company is a body corporate, incorporated by special act of the legislature of Connecticut in the year 1810, entitled "An act to incorporate the Hartford Fire Insurance Company." It is agreed that said act and any general or special laws of the State of Connecticut amending said charter, specially the acts approved June 14, 1853, May 27, 1857, June 8, 1865, and April 30, 1913, may be referred to and read from the printed volumes of the laws of Connecticut with the same effect as if duly certified copies of said charter and amendatory acts had been produced and incorporated in this agreed statement. Pursuant to an amendatory act, approved June 11, 1853, the par value of the shares was changed from \$50 to \$100.

At the beginning of the year 1906, the capital stock outstanding was \$1,250,000, and in that year it was increased by the issue of \$750,000, which was offered to the then existing stockholders at \$500 per share and subscribed for by them or their assignees.

At the time of the death of the said Frank S. R. Brown, the capital stock of the said Hartford Fire Insurance Company, issued and outstanding, consisted of 20,000 shares, of the par value of \$100 each, making a total issue of \$2,000,000.

On February 1, 1919, the estate of Frank S. R. Brown, deceased, was settled by his administrator, by the passage of an administration account in the Orphans' Court of Baltimore City, pursuant to which the said 41 shares of stock in the Hartford Fire Insurance Company were forthwith distributed to the plaintiff as guardian of the infant son of the decedent, namely, Frank R. Brown.

On or about February 21, 1919, six of said 41 shares were sold by the plaintiff pursuant to an order of the Orphans' Court of Baltimore City, for \$4,544.64, in order to obtain funds to make good an overpayment by the administrator of Frank S. R. Brown, deceased.

Subsequently, in the year 1919, the Hartford Fire Insurance Company, pursuant to the authority granted by said acts of June 8, 1865, and April 30, 1913, increased its capital stock from 20,000

18 shares of a par value of \$100 each to 40,000 shares of a par value of \$100 each, and to each of its old stockholders was accorded the right of subscribing pro rata to their quota of the new or increased stock, at \$150 per share, pursuant to a resolution of a special meeting of the stockholders held on June 25, 1919, a copy of which is hereto attached. The plaintiff, as guardian of the said Frank R. Brown, infant, accordingly became entitled to subscribe to 35 new or additional shares of stock at \$150 per share, and this right the plaintiff, pursuant to an order of the Orphans' Court of Baltimore City, sold for \$12,546.80 on the 19th day of July, 1919. A copy of its petition to the Orphans' Court and the order of said court thereon is hereto attached.

22 Upon the foregoing petition of Safe Deposit and Trust Company of Baltimore, guardian of Frank S. R. Brown, minor, it is ordered by the Orphans' Court of Baltimore City this 1st day of July, 1919, that said guardian be and it is hereby authorized and empowered to sell the rights to subscribe to 35 shares additional stock of the Hartford Fire Insurance Company of Hartford, Conn., at their current market value for cash and to transfer and deliver the same to the purchaser thereof.

MEYER J. BLOCK.

(Signed) HARRY C. GAITHER.

WILLIAM M. DUNN.

23 Page 4 of return.

Individual income tax return for calendar year 1919. Frank R. Brown, by Safe Deposit and Trust Co. of Balto., guardian, 13 South St., Balto., Md.

1. Did you make a return for 1918? No. 4. Were you married and living with wife (or husband) Dec. 31, 1919? No. 7. Write "R" if this return shows income received, or "A" if it shows income accrued. R. 10. Did you, your wife (or husband) or minor children receive any interest on U. S. Liberty Bonds or any other income not reported elsewhere in this return or in a separate return? \$14,000 U. S. lib 4 1/2. \$135.88.

NOTE.—This estate received from the proceeds of sale of rights to subscribe to Hartford Fire Ins. Co. stock the sum of \$12,546.80. The stock prior to the sale of the above rights was quoted at \$8.50, bid, and after the sale of the rights at \$5.10, bid, making a reduction of \$3.40 per share. Although Regulations 45 provides that the proceeds of sale of rights are income, we have asked the Bureau to reconsider this ruling, and pending receipt of advices thereon the above sum has not been included in the return.

We apprehend that any future sales of said stock would result in a loss, which would not be compensated for by the income collected during the year of the sale, although if the ruling above referred to is sustained the \$12,546.80 would be subject to tax as a gain.

#### Calculation of tax.

M. Net income shown on page 2, Item J. \$576.61  
N. Less personal exemption (see Instruction VII) 1,000.00  
Q. Less normal tax of 2% on amount of Item F 8.80

24 Page 2 of return.

1. Profit from sale of land, buildings, stocks, bonds, and other property and from liquidating dividends:

1. Kind of property. 6 shares. 2. Name of purchaser or broker. Hartford Fire Ins. Co. 3. Sale price or liquidating dividends. \$4,544.64. 4. Date acquired. 1919. 5. Cost or market value Mar. 1, 1913, if acquired prior thereto \$3,900.

Net profit (total of cols. 3 and 7 minus total of cols. 5 and 6). \$644.64.

F. Interest on corporation bonds containing tax-free covenant, on which a tax of 2% was paid by debtor corporation (including such interest received through partnerships, personal service corporations, and fiduciaries reporting on calendar year basis). \$4.00.

G. Other income (not including dividends, which should be reported in Item K): Amount paid for you by debtor corporation on tax-free covenant bonds (Item Q, page 1). Amount received. \$8.80.

Total, \$8.80.

H. Total net income from above sources. \$1,053.44.

I. General deductions not included above:

2. Taxes paid. \$128.32. 5. Bad debts and other deductions, if any (attach detailed statement). \$88.51.

Total, \$516.83.

J. Total net income on which normal tax is to be calculated (H minus I) (Enter as Item M, page 1). \$576.61.

K. Cash or stock dividends from corporations which are taxable by the United States upon any portion of their net incomes (including dividends received through partnerships, personal service corporations, and fiduciaries reporting on a calendar year basis). \$1,538.12.

L. Total net income (if this amount is over \$5,000, make your return on Form 1040). \$2,114.73.

25 SAFE DEPOSIT AND TRUST COMPANY OF  
BALTIMORE.

13 South Street.

Cable "Safdeposit."

BALTIMORE, July 14, 1920. P/W

COMMISSIONER OF INTERNAL REVENUE,

*Washington, D. C.*

DEAR SIR: We are transmitting herewith claim for refund of income tax for 1919, assessed against, and paid under protest by, this company as guardian of Frank R. Brown, infant.

The question raised by the application is whether the proceeds of sale of a stockholder's rights to subscribe to additional shares of new stock constitute in all cases taxable income in their entirety, or whether the transaction is not to be regarded rather as a sale of a part of the stockholder's principal, so that the proceeds would be taxable, if at all, only to the extent of the gain, if any, over the cost or value of that part of the principal so disposed of. We understand that the department has ruled that the whole proceeds of sale of the stockholder's rights constitute income in all cases and desires no further argument, but will cooperate with us in bringing the matter to a speedy test in the courts.

We therefore respectfully ask that if the department adheres to its rulings it will act promptly, so that we may institute the test suit immediately, and obtain a judicial decision, if possible, in August.

Very truly yours,

(Signed) GEO. PAUSCH,  
*Auditor.*26 Treasury Department, Bureau of Internal Revenue. Form 46—Revised  
Jan., 1920. Ed. 200,000.

## CLAIM FOR REFUND.

Taxes erroneously or illegally collected. Also amounts paid for stamps used in error or excess.

## IMPORTANT.

This claim should be forwarded to the Collector of Internal Revenue to whom the tax was paid and must be accompanied by collector's receipt therefor.

STATE OF MARYLAND, }  
CITY OF BALTIMORE. }*ss:*

SAFE DEPOSIT AND TRUST COMPANY OF BALTIMORE, GUARDIAN OF FRANK R. BROWN.

*13 South Street, Baltimore, Md.*

This deponent being duly sworn according to law deposes and says that this claim is made on behalf of the claimant named above, and that the facts stated below with reference to the claim are true and complete:

1. Business engaged in by claimant.
2. Character of assessment or tax. Income tax for 1919.
3. Amount of assessment or stamps. \$1,130.77.

4. Amount now asked to be refunded (or such greater amount as is legally refundable), \$1,130.77.

5. Date of payment of assessment or purchase of stamps, July, 1920.

Dependent verily believes that the amount stated in Item 4 should be refunded and claimant now asks and demands refund of said amount for the following reasons:

The tax assessment was based upon the theory that the whole proceeds of sale of the "rights" by Safe Deposit and Trust Company of Baltimore, guardian, for Frank R. Brown, infant, to subscribe at \$150 per share to 35 shares of the Hartford Fire Insurance Company, which right accrued to the said infant's estate by reason of ownership of thirty-five shares of the capital stock of said Hartford Fire Insurance Company, distributed to the infant in February, 1919, in the settlement of the estate of his father, who died on January 16, 1918, constitutes taxable income for 1919. The claimant on the other hand contends that the transaction in question amounts to a sale of a part of the ward's original capital, and that if any tax is payable (which the claimant denies) the tax is only on so much of the proceeds of sale as represents a gain on the value at the time of acquisition of the thing sold, namely, a fractional interest in the company equal to the difference between the fraction of the entire capital stock owned by the claimant's ward prior to the increase of stock, and the fractional interest owned by him after the increase of stock and the sale of his "rights."

See copy of letter to Hon. Joshua W. Miles, collector of internal revenue dated July 9th, 1920, hereto attached.

And this dependent further alleges that the said claimant is not indebted to the United States in any amount whatever, and that no claim has heretofore been presented, except as stated herein, for the refunding of the whole or any part of the amount stated in Item 3.

(Signed) SAFE DEPOSIT & TRUST CO. OF BALTIMORE, *Guardian*.

By GEO. PAUSCH, Auditor.

Sworn to and subscribed before me this 13 day of July, 1920.

[N. S.]

WM. B. STEWART, *Notary Public*.

(This affidavit may be sworn to before a deputy collector of internal revenue without charge.)

27 [Reverse side of Form 46 blank.]

28 Income, War-Profits, and Excess-Profits Tax.  
Notice and Demand for Tax.  
Form 1-17a—Revised Jan., 1920.  
United States Internal Revenue Service.

Old balance.	Date.	Tax.	Amount paid.	Balance due.	Remarks.
				\$1,130.77	June '20 Supl. PO 10

Notice is hereby given that there has been assessed against you the amount of tax stated on this notice. Demand is hereby made for the immediate payment of said tax. If payment is not made within ten days after date of this notice, the act provides that a penalty of 5 per cent of the amount of tax due will be added, plus interest at the rate of 1 per cent per month, from July 11, 1920, until paid.

JOSHUA W. MILES.

Date, July 1, 1920.  
Frank R. Brown,  
% Safe Deposit & Trust Co. of Balto.,  
13 South St.,  
Baltimore, Md.

June '20, Supl PO 10

To avoid penalty and interest this tax must be paid to the collector of internal revenue at \_\_\_\_\_, not later than July 10, 1920.

DATE, .....	Collector's paid stamp.
To the COLLECTOR OF INTERNAL REVENUE:	
I enclose herewith the sum of \$ ..... in payment of the tax shown above.	
Name, Frank R. Brown.	Paid July 10, 1920.
Address, .....	

Return this form with remittance.

Safe Deposit and Trust Company of Baltimore.

13 South Street.

Cable "SafeDeposit."

BALTIMORE, July 9th, 1920. W

Honorable JOSHUA W. MILES, COLLECTOR,

*Custom House, Baltimore, Md.*

DEAR SIR: We have received your notice and demand for eleven hundred thirty dollars and seventy-seven cents (\$1,130.77), income tax for 1919 assessed against Frank R. Brown, infant, for whom this company is guardian. In order to avoid the threatened penalties and liability of property to distraint, we are paying the amount demanded under protest, and hereby give notice that the same is illegally assessed and demanded, and that if refund is refused we intend to sue to recover it back.

The facts are in brief as follows:

In the administration of the estate of Frank S. R. Brown, deceased (father of our ward, Frank R. Brown), by an administration account passed in the Orphans' Court of Baltimore City on February 1st, 1919, 35 shares of capital stock of the Hartford Fire Insurance Company, a Connecticut corporation, were distributed to this company as guardian of Frank R. Brown, infant. Frank S. R. Brown died January 16, 1918, and the above stock was quoted on that date at \$680 per share bid, and \$700 per share asked. At the time of the administration account, the stock was quoted at \$705 per share bid, and \$720 per share asked. The stock was appraised by the Orphans' Court appraisers in the inventory at \$650 per share.

In the course of the year 1919 and after the receipt of 35 shares of the stock by this company as guardian for Frank R. Brown, the Hartford Fire Insurance Company doubled its capital stock, increasing the number of shares from 20,000 to 40,000, and offered the new shares to the old stockholders, pro rata, at \$150 per share. This company as guardian of said Frank R. Brown sold his rights to subscribe to thirty-five shares of this capital stock in 1919 for \$12,646.80.

The tax assessed against our ward's estate, and which we are now paying under protest, is based upon the theory that the whole pro-

ceeds of this sale constitute income of our ward's estate. We, on the contrary, contend that the sale of these so-called rights constitutes a sale of a part of the original capital derived by our ward from his father's estate. Prior to the increase of stock our ward was entitled to stock representing 35 twenty-thousandths of the net assets of the company, and after the increase and sale he was entitled to 35 forty-thousandths of the same assets.

Accordingly, we submit that the sale of the "rights" is clearly a sale of a part of the original capital, and is taxable, if at all, only to the extent that the proceeds of sale of a capital asset constitute taxable income.

The fact that a part of the original capital was sold was clearly reflected in the market price of the original 35 shares held by the ward's estate, which after the increase of stock dropped to \$510 bid per share.

Accordingly we contend:

1. That the tax is illegal and that no part of the proceeds of sale of the rights is taxable income.
2. Even if a part of the proceeds is taxable income, the amount is so small that added to the other taxable income as shown in the original return, produces no tax for 1919 upon our ward's estate.
3. The amount of the assessment is excessive and calculated on erroneous and illegal basis, even if a tax is payable.

Very truly, yours,

(Signed) GEO. PAUSCH,  
*Auditor.*

P. S. The total number of shares of Hartford Fire Insurance Co. received by our ward's estate amounted to 41, but 6 shares were sold prior to the issuance of the rights, which related only to the 35 shares mentioned in the above letter.

31 IT:H:CL RDS-3.

SAFE DEPOSIT AND TRUST COMPANY OF BALTIMORE,  
*13 South Street, Baltimore, Maryland.*

SIRS: Your claim for the refund of \$1150.77, individual income tax paid by your company as guardian of Frank R. Brown for the year 1919, has been examined.

It appears that in February, 1919, the company as guardian of Frank R. Brown, received thirty-five shares of the capital stock of the Hartford Fire Insurance Company from the estate of Frank S. R. Brown, deceased, father of the ward. Subsequently during the year 1919, the Hartford Fire Insurance Company doubled its capital stock and offered new shares to the old stockholders in proportion to the number of shares previously held, and your company thereupon sold the rights accruing to the ward to subscribe to the new stock.



In preparing a return for 1919 the company was required to report as income the entire proceeds of the sale.

It is your contention that the transaction represented the sale of a portion of the ward's original capital derived from his father's estate and that the proceeds did not constitute income, and that if any tax is payable on account of the transaction it is only on so much of the proceeds as exceeded the cost or value of the principal stock involved.

You are advised that in cases where corporations desiring to secure additional capital propose to issue and sell further shares of stock, reserving to their stockholders the right to subscribe for, at par or any other stipulated price, a certain number of shares of the new stock issue proportionate to the number previously held, and if such stockholders sell their rights, it is held that the proceeds of such sale are in their entirety income for the year in which the rights are sold and should be so returned by the stockholders. It will, therefore, be seen that this bureau acted in accordance with the requirements of the regulations in assessing the above tax and the claim is accordingly hereby rejected.

Respectfully,

(Signed) WILLIAM M. WILLIAMS,

*Commissioner.*

R-ar-6

There being no further evidence offered by either party, the defendant, Joshua W. Miles, collector of internal revenue for the District of Maryland, offered the following prayer, which the court refused:

"The defendant prays the court to instruct itself sitting as a jury that the plaintiff has offered no evidence in this case legally sufficient to entitle it to recover, and therefore the verdict of the court sitting as a jury shall be for the defendant." (Refused.)

And the plaintiff (among other reasons for rejection of said prayer) contended that the proceeds of sale of the said rights to subscribe to new shares of stock of the Hartford Fire Insurance Company, mentioned in the foregoing stipulation, were proceeds of sale of a capital asset; and that if the Revenue Act of 1918 should be construed to tax as income (as claimed by the defendant) the whole of such proceeds and not merely so much thereof as might represent profit over the original cost or value of the portion of capital sold, then the said act is in excess of the power conferred by the sixteenth amendment to the Constitution of the United States, and being a direct tax upon capital, levied without apportionment among the States, is unconstitutional, null, and void.

To which ruling of the court in refusing the defendant's above prayer, defendant excepted and prays the court to sign this, his bill

of exceptions, which is accordingly done this 20 day of June, 1921.

JOHN C. ROSE, [SEAL]

*United States District Judge for District of Maryland.*

Approved as to form.

ARTHUR W. MACHEN, JR.,

*Attorney for Plaintiff.*

33 Petition for writ of error and order of court allowing writ of error.

*Filed 25th June, 1921.*

In the District Court of the United States for the District of Maryland.

SAFE DEPOSIT AND TRUST COMPANY OF BALTIMORE,  
guardian of Frank R. Brown,

*vs.*

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE,  
etc.

No. 947. Law.

Petition for writ of error.

To the Honorable JOHN C. ROSE, *District Judge:*

The petition of Joshua W. Miles, collector of internal revenue for the District of Maryland, the defendant in the above-entitled case, prays that he may be allowed a writ of error to the Supreme Court of the United States from the judgment entered in said case on the thirty-first day of May, nineteen hundred and twenty-one; that a writ of error and citation may be issued and served upon the Safe Deposit and Trust Company of Baltimore, guardian of Frank R. Brown, the plaintiff in the above-entitled case, or its attorney; that the record of the proceedings in said case be transmitted to the said Supreme Court of the United States and that the said judgment be reversed, in so far as the same is in favor of the said plaintiff, and that judgment be entered in favor of the defendant; and that upon the service of a citation, said writ of error may operate as a supersedeas until the final disposition of the cause by the Supreme Court of the United States.

And in support of this petition your petitioner hereby presents his assignment of errors.

ROBERT R. CARMAN,

*United States Attorney, Attorney for Defendant.*

The prayer of the foregoing petition is granted and a writ of error ordered to issue as prayed, the same to act as a supersedeas of the judgment herein, and of the costs and damages on appeal.

JOHN C. ROSE,

*District Judge.*

Dated June 25, 1921.

*Filed 25th June, 1921.*

In the District Court of the United States for the District of Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,	} No. 947. Law.
Guardian of Frank R. Brown.	
<i>vs.</i>	
JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE.	
<i>Assignment of errors.</i>	

Now comes Joshua W. Miles, collector of internal revenue for the District of Maryland, the defendant, in the above-entitled case, and files the following assignment of errors, upon which he will rely upon his prosecution of the writ of error allowed in the above-entitled cause from the judgment entered by this honorable court on the thirty-first day of May, nineteen hundred and twenty-one.

First.—That the said district court erred in refusing the prayer offered by the defendant, which prayer is as follows, viz:

"The defendant prays the court to instruct itself sitting as a jury that the plaintiff has offered no evidence in this case legally sufficient to entitle it to recover, and therefore the verdict of the court sitting as a jury shall be for the defendant."

ROBERT R. CARMAN,

*United States Attorney for District of Maryland,*

*Attorney for Defendant.*

35 UNITED STATES OF AMERICA, *vs.*

*The President of the United States, to the Honorable the Judges of the District Court of the United States for the District of Maryland.*

Greeting:

Because in the record and proceedings, as also in the rendition of the judgment of a plea which is in the said District Court before you, or some of you, between The Safe Deposit and Trust Company of Baltimore, guardian of Frank R. Brown, plaintiff, and Joshua W. Miles, collector of internal revenue for the District of Maryland, defendant, a manifest error hath happened, to the great damage of the said defendant as by his complaint appears. We being willing that error, if any hath been, should be duly corrected, and full and speedy justice done to the parties aforesaid in this behalf, do command you, if judgment be therein given, that then under your seal, distinctly and openly, you send the record and proceedings aforesaid, with all things concerning the same, to the Supreme Court of the United States, together with this writ, so that you have the same

in the said Supreme Court at Washington, within 30 days from the date hereof, that the record and proceedings aforesaid being inspected, the said Supreme Court may cause further to be done therein to correct that error, what of right, and according to the laws and customs of the United States should be done.

Witness the Honorable Joseph McKenna, Senior Associate Justice of the Supreme Court of the United States, the 25th day of June, in the year of our Lord one thousand nine hundred and twenty-one.

ARTHUR L. SPAMER,

*Clerk District Court of the United States for the District for Maryland.*

Allowed by

JOHN C. ROSE,

*U. S. District Judge.*

36 UNITED STATES OF AMERICA, *vs.*

*To the Safe Deposit and Trust Company of Baltimore, Guardian of Frank R. Brown.*

Greeting:

You are hereby cited and admonished to be and appear at a Supreme Court of the United States, at Washington, within thirty days from the date hereof, pursuant to a writ of error, filed in the clerk's office of the district court of the United States for the District of Maryland, wherein Joshua W. Miles, collector of internal revenue for the District of Maryland, is plaintiff in error and you are defendant in error, to show cause, if any there be, why the judgment rendered against the said plaintiff in error, as in the said writ of error mentioned, should not be corrected, and why speedy justice should not be done to the parties in that behalf.

Witness, the Honorable John C. Rose, district judge of the United States for the District of Maryland, this twenty-fifth day of June, in the year of our Lord one thousand nine hundred and twenty-one.

JOHN C. ROSE,

*U. S. District Judge.*

[SEAL]

Attest:

ARTHUR L. SPAMER,

*Clerk District Court of the United States for the District of Maryland.*

Service of the within citation acknowledged this 30th day of June, 1921.

ARTHUR W. MACHEN, Jr.,

*Attorney for Safe Deposit and Trust Company of Baltimore, Guardian of Frank R. Brown.*

37 Stipulation of Counsel as to Making up Record on Appeal.

*Filed 25th June, 1921.*

In the District Court of the United States for the District of Maryland.

SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE, Guardian of Frank R. Brown, <i>vs.</i> JOSHUA W. MILES, COLLECTOR OF INTERNAL revenue.	}	No. 947. Law.
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Stipulation of Counsel as to Making Up Transcript of Record on Appeal.

It is stipulated and agreed by and between counsel for the respective parties in the above entitled case that the transcript of record on defendant's appeal by writ of error to the Supreme Court of the United States shall consist of the following, viz:

1. Declaration.
2. Pleas.
3. Opinion of court.
4. Verdict.
5. Judgment.
6. Certificate of probable cause.
7. Bill of exceptions.
8. Assignment of errors.
9. Stipulation of counsel as to making up transcript of record on appeal.

ARTHUR W. MACHEN, Jr.,  
*Attorney for Plaintiff.*

ROBERT R. CARMAN,  
*United States Attorney for District of Maryland,*  
*Attorney for Defendant.*

38 Memorandum of the Clerk.

- (1) Petition for writ of error filed 25th June, 1921.
  - (2) Writ of error granted 25th June, 1921.
  - (3) Writ of error dated 25th June, 1921.
  - (5) Citation. Dated 25th June, 1921.
- Acknowledgment of service, 30th June, 1921.

Order to Transmit Record.

In pursuance of the writ of error aforesaid, and according to the statute in such case made and provided, and of the Order of Court here, a record of the judgment aforesaid, with all things thereunto

relating, together with the said writ of error annexed, is hereby transmitted to the Supreme Court of the United States accordingly.

Test:

ARTHUR L. SPAMER,

*Clerk.*

39 UNITED STATES OF AMERICA, DISTRICT OF MARYLAND, *to wit:*

I, ~~Arthur~~ L. Spamer, clerk of the District Court of the United States for the District of Maryland, do certify that the foregoing is a true transcript of the record and proceedings of the said district court, together with all things thereunto relating, in the therein entitled cause.

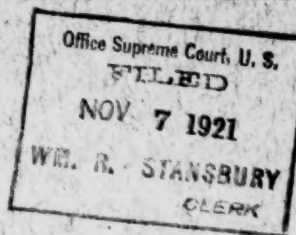
In testimony whereof, I hereunto set my hand and affix the seal of said district court, this 11TH day of July, 1921.

[SEAL.]

ARTHUR L. SPAMER,

*Clerk.*

(Endorsement on cover:) File No. 28371. Maryland D. C. U. S. Term No., 416. Joshua W. Miles, Collector of Internal Revenue for the District of Maryland, plaintiff in error, vs. The Safe Deposit and Trust Company of Baltimore, guardian of Frank R. Brown. Filed July 18th, 1921. File No. 28371.



# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1921.

---

**No. 416**

---

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE  
FOR THE DISTRICT OF MARYLAND,

*Plaintiff in Error,*

v.

SAFE DEPOSIT AND TRUST COMPANY OF BAL-  
TIMORE, GUARDIAN OF FRANK R. BROWN,

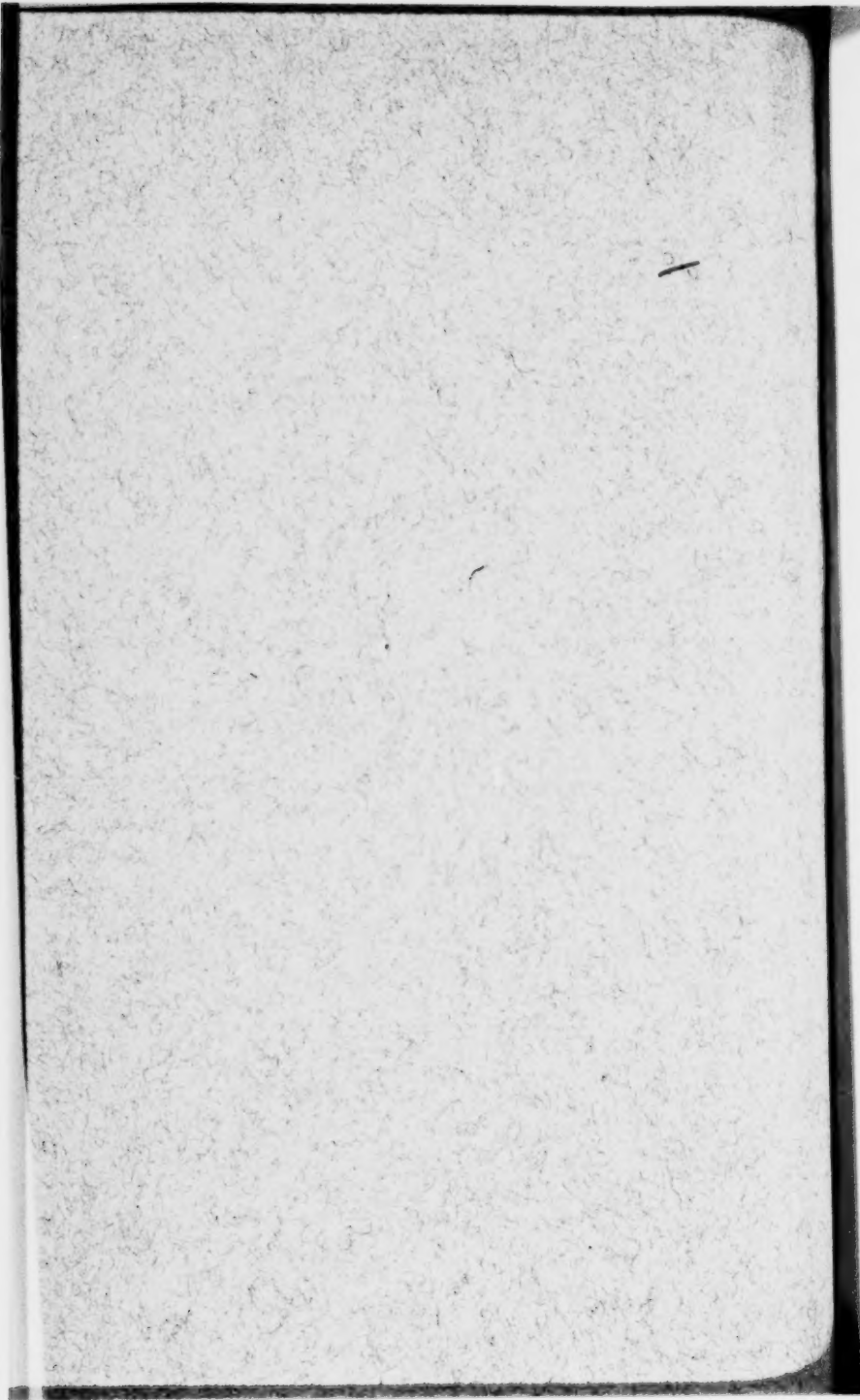
*Defendant in Error.*

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IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF MARYLAND.

---

**MOTION TO ADVANCE UNDER RULE 26**





# SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1921.

---

**No. 416**

---

JOSHUA W. MILES, COLLECTOR OF INTERNAL REVENUE  
FOR THE DISTRICT OF MARYLAND,

*Plaintiff in Error,*

*v.*

SAFE DEPOSIT AND TRUST COMPANY OF BAL-  
TIMORE, GUARDIAN OF FRANK R. BROWN,

*Defendant in Error.*

---

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF MARYLAND.

---

## MOTION TO ADVANCE UNDER RULE 26

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*To the Honorable the Chief Justice and the Associate Jus-  
tices of the Supreme Court of the United States:*

Comes now Safe Deposit and Trust Company of Baltimore,  
guardian of Frank R. Brown, defendant in error, and respect-  
fully prays this Honorable Court that this case may be ad-  
vanced upon the docket of this Court and set down for oral  
argument upon such convenient day in the reasonably near  
future as this Honorable Court may fix; and for reasons for  
this motion respectfully shows:

## I.

This is an action to recover back certain income tax for the year 1919, alleged to have been illegally demanded by the plaintiff in error, and paid by the defendant in error under protest.

The only question in the case is whether, as contended by the plaintiff in error, *the whole proceeds of sale* by a stockholder of his "rights" to subscribe to his quota of new shares upon an increase of capital stock by the corporation constitute income taxable under the Revenue Act of 1918 and under the Sixteenth Amendment, or whether, as contended by the defendant in error and held by the Court below, such sale of "rights" is a *sale of part of the stockholder's original capital*, so that only so much, if any, thereof as represents a gain over the original cost or value is taxable income.

## II.

The question involved is one of great public and general interest. Your petitioner alone, which is a trust company engaged in business in Baltimore, has been repeatedly confronted with the same question in the administration of its trusts, and a number of other cases in which your petitioner is interested as trustee, executor or administrator, are awaiting the decision of this Court in this case.

In addition to the cases in which your petitioner is directly interested, your petitioner is informed that a vast number of cases throughout the country involving precisely the same question as involved in this case are awaiting the decision of this case. Since the decision below your petitioner has received numerous letters from various parts of the country, from trust companies, lawyers, and others having to do with the administration of trusts and estates, inquiring as

to the progress of this case and expressing a desire that the questions involved should be speedily determined by this Court.

### III.

Notice of this motion has been duly given to the plaintiff in error, and we are authorized by the Solicitor General to state that he has no objection to the granting of this motion, provided the case is set for a day not earlier than the first Monday in January, 1922.

Respectfully submitted,

ARTHUR W. MACHEN, JR.,

*For Petitioner.*



RECEIVED  
JAN 10 1921  
U.S. DEPT. OF JUSTICE

No. 410

**In the Supreme Court of the United States**

**January Term, 1921**

**JOSUAH W. HARRIS, COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF MARYLAND, PLAINTIFF  
IN ERROR.**

**THE SAFE DEPOSIT AND TRUST COMPANY OF BALTIMORE, GUARDIAN OF FRANK R. BROWN,**

**IN ERROR, VS. THE GOVERNMENT OF THE UNITED STATES  
FOR THE DISTRICT OF MARYLAND.**

**WRIT OF HABEAS CORPUS OF PLAINTIFF IN ERROR.**

RECEIVED JAN 10 1921 U.S. DEPT. OF JUSTICE

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# In the Supreme Court of the United States.

OCTOBER TERM, 1921.

JOSHUA W. MILES, COLLECTOR OF INTERNAL  
Revenue for the District of Mary-  
land, plaintiff in error,

*v.*

THE SAFE DEPOSIT AND TRUST COMPANY  
of Baltimore, Guardian of Frank R.  
Brown.

No. 416.

*IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES  
FOR THE DISTRICT OF MARYLAND.*

## BRIEF ON BEHALF OF PLAINTIFF IN ERROR.

### STATEMENT OF THE CASE.

The defendant in error, on November 6, 1920, filed a declaration in the United States District Court for the District of Maryland against the plaintiff in error to recover the amount of \$1,130.77 which had been paid by the defendant in error to the plaintiff in error under protest as taxes for the year 1919 on income alleged to have been derived by the defendant in error from the sale of certain rights to subscribe for new shares in the Hartford Fire Insurance Company, a corporation organized under the laws of the State of



Connecticut. (R. 1-4.) Issue was joined and the case was tried before the court without a jury on a stipulation of facts with certain exhibits. (R. 10-19.)

From this stipulation the following facts appear:

The defendant in error is a corporation organized under the laws of the State of Maryland and authorized to act as guardian, and was, on January 30, 1919, appointed by the Orphans Court guardian of Frank R. Brown, the son of Frank S. R. Brown. The father died intestate on January 16, 1918, and, as next of kin, his son became entitled to 35 shares of the capital stock of the Hartford Fire Insurance Company, which stock was transferred to the defendant in error as his guardian and is still held by it in such capacity.

The Hartford Fire Insurance Company was incorporated under the laws of the State of Connecticut. On June 8, 1865 (Private Acts of the General Assembly of the State of Connecticut, May session, 1865, page 81), it was authorized to increase its capital to an amount not exceeding 30,000 shares of the par value of \$100 each, it being provided:

Each person who may be a stockholder at the time or times when such addition or additions shall be made shall be entitled to a pro rata share of said addition to the capital stock, to be subscribed for, or taken by them, under and in pursuance of such regulation as may be adopted by the directors.

By an act of the General Assembly of the State of Connecticut approved April 30, 1913, the Hartford Fire Insurance Company was authorized to increase its

stock to an amount not exceeding in the aggregate \$10,000,000 in shares of the par value of \$100 each, but this statute granted no right of preemption to the existing shareholders in the company.

At the date of the death of Frank S. R. Brown, the father, the capital stock of the Hartford Fire Insurance Company, issued and outstanding, under the authority of the two statutes referred to above, consisted of 20,000 shares of a par value of \$100 each. In the year 1919 the insurance company, under the authority of the acts aforesaid, increased its capital stock from 20,000 shares of a par value of \$100 each to 40,000 shares of the same par value, and the resolution of the stockholders authorizing this increase (R. 13) provided that the right to subscribe to the new issue should be offered to the stockholders at the price of \$150 per share in the proportion of one share of new stock to one share of old stock; and that the directors should have power to dispose of the shares not subscribed and paid for by the old stockholders as they might determine to be for the best interests of the company.

The defendant in error, pursuant to an order of the Orphans Court, sold the rights to subscribe to 35 shares of the stock of the insurance company owned by its ward, Frank R. Brown, on the 19th day of July, 1919, for \$12,546.80. The Commissioner of Internal Revenue, holding that this entire amount was income for the year 1919 under the provisions of the act approved February 24, 1919, c. 18, 40 Stat. 1057, assessed, and the plaintiff in error

collected, a tax upon said amount of \$1,130.77. The defendant in error, claiming that none of the amount so received was income within the meaning either of the act or of the eighteenth amendment to the Constitution of the United States, brought an action to recover the whole of the amount so assessed and collected.

The District Court held that the proceeds of the sale of the rights was income to some extent, but not to the extent claimed by the plaintiff in error. The court held that the defendant in error was only assessible upon the gain derived from the sale, which gain was the difference between what the new stock cost and what was received for it. In order to determine what the cost of the stock was, the court took the value of the old shares as assessed by the United States for the estate tax, namely, \$710 per share, and to this added \$150, which would have to be paid in order to obtain a share of the new stock. The total cost thus reached, namely, \$860, was then divided by two to reach the average cost of the old and new shares combined, namely, \$430, and this amount, being deducted from the amount received per share for the rights plus \$150, gave a resulting gain of \$78.48 a share, for which amount, it was held, the defendant in error was properly assessible. (*Safe Deposit and Trust Company of Baltimore v. Miles, Collector*, 273 Fed. 822.)

To this judgment this direct writ of error was sued out under the authority of section 238 of the

Judicial Code, for the reason that the construction or application of the Constitution of the United States is involved in the case.

#### ASSIGNMENT OF ERRORS.

The only error assigned is that the court erred in refusing to enter a verdict for the defendant, the plaintiff in error here, for the reason that the plaintiff, the defendant in error here, had offered no evidence legally sufficient to entitle it to recover.

#### STATUTES INVOLVED.

Act of February 24, 1919, c. 18, 40 Stat. 1057:

SECTION 200. That when used in this title  
\* \* \* the term "fiduciary" means a guar-  
dian \* \* \*.

SECTION 225. That every fiduciary \* \* \*  
shall make under oath a return for the indi-  
vidual, estate, or trust for which he acts  
\* \* \*.

Fiduciaries required to make returns under this act shall be subject to all the provisions in this act which apply to individuals.

SECTION 212. (a) That in the case of an individual the term "net income" means the gross income as defined in section 213, less the deductions allowed by section 214.<sup>1</sup>

SECTION 213. That for the purposes of this title \* \* \* the term "gross income"—  
(a) Includes gains, profits, and income derived from \* \* \* sales, or dealings in property, whether real or personal, growing out of the

<sup>1</sup> Section 214 of the act contains no deductions which have any application to the case at bar.

ownership or use of or interest in such property; also from \* \* \* gains or profits and income derived from any source whatever.

SECTION 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—

(1) In the case of property acquired before March 1, 1913, the fair market price or value of such property as of that date; and

(2) In the case of property acquired on or after that date, the cost thereof \* \* \*.

#### QUESTION INVOLVED.

The question involved in the case at bar is whether or not the sale of a right granted to an old stockholder to subscribe to new stock in a corporation produces any income at all and, if so, to what extent; and, more particularly, whether the extent of the income is to be determined, not by the actual cost of the new share, but by an average cost attributed to the new share by derivation from the cost of the old shares.

#### ARGUMENT.

(a) That the sale of the rights to subscribe to the stock in the Hartford Fire Insurance Company in the case at bar produced taxable income to some extent is settled by the decisions of this court in *Eisner v. Macomber*, 252 U. S. 189, 212, and *Merchants Loan and Trust Company v. Smietanka*, 255 U. S. —, with the cases relied upon in the latter decision, namely, *Hays v. Gauley Mountain Coal Company*, 247 U. S. 189, and *United States v.*

(Cleveland, Cincinnati, Chicago & St. Louis Railway Company, 247 U. S. 195. In *Eisner v. Macomber* this court said:

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the sixteenth amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale.

In *Merchants Loan and Trust Company v. Smickala* it was held that where stock is sold the entire difference between the cost of the stock and the selling price is taxable gains or profits, although the selling price may represent to some extent the conversion of capital assets and the appreciation in value of such capital assets through a period of time. The question, therefore, as to whether or not there was any taxable income at all in the case at bar is no longer open in this court, as it may have been in the court below.

(b) The method of determining the amount of taxable income derived from the sale of the rights in the case at bar adopted by the Treasury Depart-

ment and enforced in the assessment in the present case is clearly based upon the actual facts as they existed. The defendant in error did sell certain valuable rights which had actually cost it nothing for the sum of \$12,546.80, and, therefore, on the face of things this entire amount must necessarily represent its gain or profit from the transaction. If for the sake of argument the assumptions adopted by the court be granted, viz. that the defendant in error actually subscribed for the stock and subsequently sold the actual certificate issued to it, the result will be the same. The cost of each share to the defendant in error would, in that event, have been \$150 and no more, and the purchase price received would have been the same amount received for the rights, plus \$150, the purchaser, of course, paying less for the rights if it was incumbent upon him or his assignee to pay the subscription price of \$150. If, therefore, it be assumed that the defendant in error purchased the share and subsequently sold it in the open market, no greater cost can be attributed to the share so sold, on the face of things, and as the facts would be, than \$150. This is the cost allowed by the Treasury Department, and, therefore, it would seem that its assessment was justified by the actual facts and the actual cost.

(c) The theory adopted and applied by the court below was that the right to subscribe to the new share of stock, being merely a derivative or offspring of the right of property in the old shares, must necessarily be charged proportionately with the cost

of said old shares. This theory is, to a certain extent, plausible, but it can only be applied properly to a case like that of the stock dividend, where the new shares are merely a dilution of the old shares, are conferred upon the stockholder, not of-right, and without any action upon his part, and result in leaving his proportionate ownership in the assets of the corporation precisely the same as before the issuance of the new shares. In that case the new shares are nothing more than a portion of the old, the old shares in a new guise, and, therefore, the cost of the old shares may properly be taken into consideration in estimating the cost of the new, and the cost of both new and old consequently averaged among the whole number of shares. These considerations, however, do not apply to the case of the granting of a right to subscribe to new shares upon the payment of a certain amount of money. In this latter case the new shares are not merely a dilution of the old, or the old under a new aspect, but are in truth new shares which have brought new capital into the company and the issuance of which may alter entirely the proportionate interest of the stockholder in the assets of the corporation. Two considerations should be borne in mind as illustrating the difference between the case at bar and the case of a stock dividend, viz.,

(1) In the case of the stock dividend, when new stock has been issued, the effect is to transfer the amount of the dividend from the surplus of the corporation to its capital account. (*Eisner v. Ma-*



*comber*, 252 U. S. 189, 210.) In other words, where, before the issuance of a stock dividend, the corporation was indebted in a certain amount to "surplus," it is, after the stock dividend, indebted in the amount of such dividend to "capital stock" instead of "surplus." No other change has taken place in the position of the corporation or of the stockholder as toward each other. In the case, however, of the issuance of rights to subscribe to new stock, as in the case at bar, when said new stock is issued, no diminution whatsoever takes place in the surplus account of the corporation. The indebtedness to capital stock is increased, but it is offset by a corresponding credit to the cash account or assets of the corporation. Indeed, where, as in the case at bar, the stock is sold for a sum greater than par, the effect will be to increase the indebtedness to "surplus" as well as to increase the indebtedness to "capital" in order to offset the corresponding credit to cash assets. It thus appears that the issuance of rights to subscribe to stock bears an entirely different aspect, in the point of view of the corporation, from that of the stock dividend.

(2) In the case of a stock dividend, as is stated above, no change is effected in the proportionate ownership of the stockholder. What it was before the issuance of the new stock, it remains after the issuance. In the case of the issuance of rights to subscribe to new stock, however, the result is entirely different. It is only in the event that the stockholder exercises the right in question that his pro-

portionate interest remains the same. To exercise this right, however, requires action upon his part which he is not compelled to take. If he decide to sell the rights, as the defendant in error did in the case at bar, the result may be that some assignee of his will subscribe to the stock, in which case his proportionate interest would evidently be altered. The same result would follow if he failed to exercise his right to subscribe but allowed it to lapse. In that event the corporation, as was expressly provided in the resolution of the stockholders in the case at bar, may dispose of the stock as treasury stock in any way it pleases and for any price, and the entrance of these new stockholders into the corporation will evidently change the proportionate standing of the old stockholder who allowed his rights to lapse. The person who purchases the rights from the stockholder may, after the purchase, determine that his interests do not permit him to exercise the right, and he may allow it to lapse. In that event, again, the stock may be sold by the directors as treasury stock and would, necessarily, stand upon the same basis as any other stock sold by the corporation to outsiders. Or the corporation, in the case of the lapse of the right to subscribe, may decide not to issue the stock at all, in which event, again, the relative position of the stockholders will be altered.

It is submitted, therefore, that the fallacy involved in the decision of the court below in the case at bar consists in assuming certain things to have happened which, in fact, need never happen, and which did

not, in fact, happen in the case at bar, viz, that every stockholder exercises his right to subscribe, so that he becomes the owner, by the exercise of such right, of new shares which are merely the offspring of his old shares. As a matter of fact, however, where the rights to subscribe are sold, the stockholder never, in fact, exercises his rights at all, the new stock, when issued, becomes the property of some third person, who may have held no old stock or with whose old stock the new stock can not be connected, and consequently in that case, which actually happened at bar, the new shares could not be said to be the offspring of the old, and the cost of the old, therefore, could not be attributed to them.

(d) If it is to be said, as it was said by the court below, that even where the shares are actually issued to assignees of the old stockholder, their cost must nevertheless be connected with, or tied up with, the cost of the old shares of the assignor, it is difficult to see why logically the court would not be compelled to hold that, in every case where a stockholder sold a portion of his holdings of stock in a corporation, it would be necessary, in order to determine his profit, to average the cost of all the shares which he happened to hold at that time. Such a course would indeed be a practical necessity, if the certificates of stock were so confounded or commingled as to make it impossible to trace the cost of the particular stock which was sold. But where, as in the case at bar, it is entirely feasible to determine precisely where the share of stock which

is sold came from, and what it cost, it appears to be contrary to common sense and practical administrative convenience to require an averaging of the cost of all the shares held by him at that time rather than to take the actual cost of the particular shares which he sold. And yet, to repeat, if the decision of the court below be sound, it would seem to be necessary to adopt this averaging method in the case of every sale of stock by a stockholder.

(c) It should be observed that the method of figuring the cost of the new share adopted by the court below, while more complicated than the method adopted by the Treasury Department, is much less complicated, as applied to the case at bar, than it would be when applied to the ordinary case. In the case at bar the defendant in error acquired all the old shares at one time and at one cost. In the ordinary case the old shares would probably have been acquired at different times and at different costs; and, in that event, it would be necessary, under the theory adopted by the court below, to average in some way the varying cost of all of the prior shares, attributing, by some method, the cost of the new shares proportionately to the cost of the old shares according to the number of such old shares purchased at any particular time. Such a method of estimating the cost of new shares issued under the right to subscribe therefor would be very difficult to apply administratively, and, by its complication, would work a hardship upon the Treasury Department and upon the taxpayer. Nothing, therefore, is to be gained by adopting this com-

plicated method rather than the simple method based on actual facts adopted by the Treasury Department.

(f) Taking the definition of income adopted by this court, and applying it to a right to subscribe to new shares, after an analysis of the nature of said right, it appears that the method adopted by the Treasury Department in the case at bar is the proper method according to the decisions of this court. The definition of income approved by this court in the case of *United States v. Phellis*, decided November 21 last, is as follows:

A gain derived from capital, not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital however invested, and coming in; that is, received or drawn by the claimant for his separate use, benefit, and disposal.

It is submitted that the entire amount received for the rights in the case at bar was income within this definition. Under the act of the General Assembly of the State of Connecticut of June 8, 1865, *supra*, and under the resolution of the stockholders of the Hartford Fire Insurance Company, the defendant in error acquired a right, growing out of its ownership in the old shares of the insurance company, to subscribe to the new shares. This right, so attached to the ownership of the old shares, did not differ, in any material respect, from the right attached to said old shares to any dividends declared by the corporation. Like the dividend it was something derived from the

capital, not gain accruing to capital, it was something of exchangeable value proceeding from the property, severed from the capital, and received by the defendant in error for its use, benefit, and disposal. If the right to receive a dividend, after declaration thereof, be assignable, and if such right be actually sold for a certain price, it certainly could not be claimed that the whole price received was not income to the stockholder, nor that the price received for said right to the dividend should be offset by a portion of the cost of the share from which the dividend proceeded, attributed to the right to the dividend because the latter was derived from the former. So, in the case of the right to subscribe to stock, the granting of it severed something from the capital and its sale produces an income, and said income can not be diminished, within the fair meaning of the definition of income as stated by this court, by offsetting against the price received some fictitious cost attributed to the right to subscribe because of its derivation from the ownership of the old shares.

(g) The method advocated by the Government in the case at bar does not work out any injustice whatsoever to the taxpayer, as might at first be supposed. It is true that, where the rights only are sold, the old shares being held, the tax computed by the Government's method is higher than if computed by the method adopted by the court below. When, however, the old shares are sold, the result will be exactly the contrary, the profit on such a sale, as esti-

mated by the Government, being less than it would be if estimated by the method adopted by the court below. Moreover, it must be remembered that the effect of the actual issue of the new shares is allowed for by the Government's method in the price received for the rights, which will measure the fall in the value of the shares on account of the issuance of the new stock. For example, the shares of the Hartford Fire Insurance Company were worth something in the neighborhood of \$700 a share at the time of the issuance of the rights to subscribe, but their value "ex rights" was somewhere about \$510 (R. 12), and it is this latter value which was the basis of the price paid for the rights in the case at bar.

CONCLUSION.

The judgment of the court below should be reversed.

JAMES M. BECK,

*Solicitor General.*

WILLIAM C. HERRON,

*Attorney.*



DEC 5 1921

WM. R. STANSBURY

CLERK

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## In the Supreme Court of the United States

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OCTOBER TERM, 1921.

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No. 416.

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JOSHUA W. MILES, COLLECTOR OF INTERNAL  
REVENUE FOR THE DISTRICT  
OF MARYLAND,

*Plaintiff in Error,*

vs.

SAFE DEPOSIT & TRUST COMPANY OF BALTI-  
MORE, GUARDIAN OF FRANK R. BROWN,

*Defendant in Error.*

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WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED  
STATES FOR THE DISTRICT OF MARYLAND.

---

### BRIEF FOR DEFENDANT IN ERROR.

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ARTHUR W. MACHEN, JR.,  
*For Defendant-in-Error.*

HERSHEY, MACHEN, DONALDSON & WILLIAMS,  
*Of Counsel.*



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# In the Supreme Court of the United States

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OCTOBER TERM, 1921.

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No. 416.

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JOSHUA W. MILES, COLLECTOR OF INTERNAL  
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OF MARYLAND,

*Plaintiff in Error,*

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SAFE DEPOSIT & TRUST COMPANY OF BALTI-  
MORE, GUARDIAN OF FRANK R. BROWN,

*Defendant in Error.*

---

WRIT OF ERROR TO THE DISTRICT COURT OF THE UNITED  
STATES FOR THE DISTRICT OF MARYLAND.

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## BRIEF FOR DEFENDANT IN ERROR.

---

### STATEMENT OF THE CASE.

This is an action to recover back money collected by the Plaintiff in Error from the Defendant in Error, as income tax for 1919, on the theory that the proceeds of sale by a stockholder of "rights" to subscribe to his quota of new shares upon an increase of capital stock by the corporation

constitute *in toto* income, and not (as contended by the Defendant in Error and held by the Court below) proceeds of sale of capital assets.

The amount involved in this particular suit is small, but the action is instituted as a test case, the decision in which will control other cases affecting the Defendant in Error as executor, trustee, or guardian, and involving much larger amounts.

The defendant pleaded the general issue—*non assumpsit* and *nunquam indebitatus* (R. 5). By agreement of parties, the case was tried by the Court (Rose, D. J.), sitting without a jury (R. 10). No evidence was offered except a stipulation setting forth certain ultimate, and also certain evidentiary facts (R. 10-12), together with certain documentary evidence thereto attached (R. 13-19).

The evidentiary and ultimate facts thus admitted are as follows:

Frank S. R. Brown, a citizen of Maryland, died intestate on January 16, 1918, leaving a widow and an infant child as his next of kin (R. 10). The Defendant in Error is the guardian of this infant son (R. 10). Among the assets of Frank S. R. Brown's estate were 41 shares of the capital stock of the Hartford Fire Insurance Company, a Connecticut corporation (R. 10-11). These 41 shares were, on February 1, 1919, distributed to the Defendant in Error as guardian of the intestate's minor son. Six out of the 41 shares were immediately sold by the Defendant in Error (R. 11), and no question arises as to them. The remaining 35 shares, however, were retained by the Defendant in Error for the account of its ward. The Federal Estate Tax was paid upon a valuation of \$710 per share for this stock (R.

12), and the market price at the time of the distribution of the intestate's estate was about the same—*i. e.*, \$705 bid, and \$720 asked, per share (R. 12).

Subsequently, but in the same year, the Hartford Fire Insurance Company, pursuant to statutory authority granted prior to the intestate's death, doubled its capital stock, and offered the new shares to the old stockholders *pro rata* at \$150 per share (R. 11).

The Defendant in Error, instead of subscribing to its quota of the new shares, sold its "rights," on July 19, 1919, for \$12,546.80 (R. 11), or \$358.48 per share.

Apart from these proceeds of sale, the net income of the ward's estate for 1919 was \$576.61, and, in addition, \$1,538.12 from dividends on stock in domestic corporations (R. 14). As the former figure was less than the statutory exemption of \$1,000, and as the total income subject to surtax was less than \$5,000, no tax at all was payable unless the proceeds of sale of the "rights" should be held taxable. The Defendant in Error in its income tax return for 1919 disclosed the facts in reference to the sale of its "rights," but contended that the proceeds of sale were not taxable income (R. 14). The Collector, however, insisted that the whole proceeds of sale constituted taxable income, so as to make the income for 1919 subject to normal tax \$13,123.41, or \$12,123.41 in excess of the exemption, and the income subject to surtax \$15,238.14. Accordingly, an assessment of \$1,130.77 was levied against the Defendant in Error (R. 16). The Plaintiff in Error demanded payment of this assessment (R. 16-17), whereupon the Defendant in Error paid the same under protest (R. 12, 17-18), and immediately appealed to the Commissioner of Internal Revenue for



a reversal of the action of the Collector and a refund of the tax (R. 12, 15-16). The Commissioner ruled adversely to the claim (R. 12, 18-19), and thereupon this action was instituted.

The stock, when sold "ex rights," dropped to \$510 bid and \$525 asked, instead of \$705 bid and \$720 asked, the price per share before the capital stock was increased (R. 12).

Judge Rose filed an opinion in which he sustained the Defendant in Error's contention that the sale of the "rights" was a sale of a part of the vendor's capital, so that the proceeds would be taxable only to the extent, if any, that they represented an increase over the original cost or value to the taxpayer (R. 6). He further held that, in determining the extent, if any, of the profit realized upon the sale of the "rights," the transaction should be envisaged as if the stockholder had first subscribed for his quota of new shares, and then immediately sold the new shares thus subscribed for; in which case, as held by Judge Rose (R. 7-8), the cost of the old and new shares would be averaged, and income tax assessed only on any profit realized over and above this average.

No exception was taken, however, by the Plaintiff in Error to Judge Rose's method of calculating the profit, if any, upon the sale of the "rights"; but the Collector planted himself firmly upon the proposition that *the whole* of the proceeds of sale constituted taxable income, and submitted (in accordance with the Maryland practice) a so-called demurrer to the evidence, or prayer that no evidence had been offered legally sufficient to entitle the Defendant in Error to recover at all (R. 19).

To the rejection of this prayer, the only exception was taken (R. 19-20). Therefore in this Court the only question is, whether the extreme contention of the Government that the *whole proceeds* of sale constitute taxable income can be maintained, so that the Defendant in Error would be entitled to recover nothing.

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# I.

## A SALE OF A STOCKHOLDER'S RIGHT TO SUBSCRIBE TO HIS QUOTA OF NEW SHARES IS A SALE OF CAPITAL ASSETS.

As all the world knows, this Court has held that a stock dividend is not income of a stockholder, and cannot constitutionally be taxed by Congress as income.

Towne vs. Eisner, 245 U. S. 418;

Eisner vs. Macomber, 252 U. S. 189.

Now, the action of the Hartford Fire Insurance Company in the present case was in substance very similar—to say the least—to a stock dividend, and indeed was virtually identical with a stock dividend, except that each stockholder was required to make a relatively small payment in order to get his quota of the new stock.<sup>1</sup>

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<sup>1</sup>We do not overlook the fact that a stock dividend is a capitalization of undistributed profits or surplus, whereas when new shares are offered to the old stockholders at par or over, but at less than their actual value, there cannot be said to be a capitalization of any undistributed profits, inasmuch as the par value of the new shares is represented by the cash paid in upon them. But while the undistributed profits to the extent of the par value of the new shares may not be capitalized and thus forever precluded from being distributed, as in the case of a stock dividend, yet they are certainly not distributed. They are retained by the corporation. Moreover, so far as a holder of old shares is concerned, they are, in part at least, as irrevocably gone as if they had been capitalized; for if they should subsequently be distributed the holders of new shares would proportionately participate in the distribution.

In the typical instance of a stock dividend, such as the Towne Case or the Macomber Case, the corporation issues new stock and offers it *pro rata* to the existing stockholders gratis; in the present case, the corporation issued new stock and offered it *pro rata* to the existing stockholders, but required them, in order to get their quota, to make a payment of \$150 per share.

In other words, when a corporation declares a stock dividend, it offers the new shares to the old stockholders for subscription *pro rata* at zero dollars per share; and conversely when a corporation increases its capital stock and offers the new shares *pro rata* to the old stockholders at a subscription price less than their real worth, it declares a stock dividend subject to the condition that each stockholder, in order to get his quota of the new or dividend stock, must pay a certain sum of money to the corporation.

Now, certainly the fact that a stockholder is required to make a cash payment in order to get his quota of the new stock, instead of getting it gratis, does not have any tendency to make the new stock, either in whole or in part, income instead of capital.

The language of this Court as to stock dividends is equally applicable to stock subscription rights. The latter, like stock dividends, are "in essence not a dividend, but rather the opposite," because the stockholder, instead of receiving money from the corporation, actually is required to pay money to it, under penalty of a diminution in the quantum of his interest in the corporate assets. As in the case of a stock dividend,—

"No part of the assets of the company is separated from the common fund, nothing distributed except paper

certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution."

Eisner vs. Macomber, 252 U. S. 189, 210.

Or again, as said by this Court in the case last cited:

"The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment." (252 U. S. 211.)

It is convenient to consider separately the three possible cases, namely:—

- (a) Where the stockholder subscribes to and still retains his new shares.
- (b) Where the stockholder subscribes to his new shares and, after they are issued, sells them.
- (c) Where the stockholder sells his subscription rights.

## (A)

*Case Where the Stockholder Subscribes to and Retains His  
New Shares.*

Although the Government seems never to have contended that a stockholder who subscribes to his quota of new shares and still retains them has received any taxable income, yet the logic of its present position would go to that extent. For, if the subscription rights are a "new thing" so that the whole proceeds of sale thereof are taxable income, then it would follow that this "new thing," when received by the stockholder, would constitute taxable income, precisely in the same way that a dividend payable in property—*e. g.*, stock of another corporation—is taxable income though not sold.

Peabody v. Eisner, 247 U. S. 347;

Rockefeller vs. United States, decided Nov. 21,  
1921;

United States vs. Phellis, decided Nov. 21, 1921.

The matter of realization of profits by sale is important only in cases of sales of *capital assets*, where a profit, or increase in value is not deemed "severed" unless realized by sale.

Eisner vs. Macomber, 252 U. S. 189, 207.

But if the subscription rights are capital assets, so that the realization by sale would be important, then *not the whole of such proceeds*, but only the part representing an increase in value would be taxable income; for this Court has squarely held that the proceeds of sale of capital assets, without deduction for their cost, are not income in any sense of the word, either gross or net.

Doyle vs. Mitchell Bros., 247 U. S. 179.

This Court there said:

\* \* \* \* The learned Solicitor General has submitted an elaborate argument in behalf of the Government, based in part upon theoretical definitions of 'capital,' 'income,' 'profits,' etc., and in part upon expressions quoted from our opinions in *Flint vs. Stone Tracy Co.*, 220 U. S. 107, 147, and *Anderson vs Forty-two Broadway Co.*, 239 U. S. 69, 72, with the object of showing that a conversion of capital into money always produces income, and that for the purposes of the present case the words 'gross income' are equivalent to 'gross receipts'; the insistence being that the entire proceeds of a conversion of capital assets should be treated as gross income, and that by deducting the mere cost of such assets we arrive at net income. \* \* \* If the gross receipts upon such conversion are to be treated as gross income, what authority have we for deducting either the cost or the previous market value of the assets converted in order to arrive at net income? The deductions specifically authorized are only such as expenses of maintenance and operation of the business and property, rentals, uncompensated losses, depreciation, interest, and taxes. \* \* \*

"Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. \* \* \*

"Understanding the term in this natural and obvious sense, it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not in most cases there results a gain that properly may be accounted as a part of the 'gross income' received 'from all sources'; and by applying to this the authorized deductions we arrive at 'net income.' In

order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration" (247 U. S. 183-5).

In a word, the subscription rights are either income, in which case they are taxable when received and even though not sold; or else they are capital, in which case, even when they are sold, the whole proceeds of sale are not taxable, but only so much as represents gain or profit.

But the rights are not income:

(1) The decisions in *Towne vs. Eisner*, 245 U. S. 418, and *Eisner vs. Macomber*, 252 U. S. 189, demonstrate that they are not.

(2) Even the Government has never attempted to tax them as income unless sold.

### (B)

#### *Case Where the Stockholder Subscribes to His New Shares and, After They Are Issued, Sells Them.*

Where a stockholder subscribes to his quota of new shares and then sells the new shares, the Government, in order to be consistent with the position which it takes in the case at bar, would have to claim that any excess realized by a stockholder on the sale of the new shares over and above the subscription price thereof should be treated as taxable income. To do so, however, would disregard the fact that the subscriber

has paid for the new shares in part by a diminution in value of his old shares. In other words, the issue of the new shares has diminished the vendor's proportionate interest in the company; and consequently the new shares represent, not only the new capital contributed to the company, but also a part of the original value of the vendor's old shares. Accordingly, a stockholder who first subscribes to his quota of new shares and then sells them should be entitled, upon any sale of the new shares, to average the subscription price of the new shares and the cost of the old shares, so that upon a resale only the excess of the amount realized over and above the average would be taxable income.

If this were not so—that is, if upon any sale by a stockholder of new shares subscribed for in the exercise of his pre-emptive right, the cost to him of the shares sold should be taken to be merely the cash which he has subscribed for them—then it would necessarily follow that upon any sale of new shares issued by way of a stock dividend their cost should be taken to be zero, so that the whole proceeds of sale would be taxable income.

But the regulations of the Treasury Department, as well as the decisions of the courts, show clearly that such is not the law, but that upon any sale of the dividend shares, their cost to the taxpayer must be computed by averaging the amount paid for the dividend shares—*i. e.*, zero—and the amount paid for the shares on which the stock dividend was declared. The regulations provide as follows:

"Stock issued by a corporation as a dividend does not constitute taxable income of a stockholder in such corporation, but gain may be derived or loss sustained by the stockholder from the sale of such stock. The amount



of taxable gain derived or deductible loss sustained from the sale of such stock, or from the sale of the stock with respect to which it is issued, shall be determined as provided in Article 1561 as amended, after the cost, or both the cost and fair market value as of March 1, 1913, if acquired prior thereto, of both the old and the new shares is determined in accordance with the following rules:

“(1) Where the stock issued as a dividend is all of substantially the same character or preference as the stock upon which the stock dividend is paid, the cost of each share, and when acquired prior to March 1, 1913, the fair market value as of such date, will be *the quotient of the cost, or such fair market value, of the old shares of stock, divided by the total number of the old and new shares*” (italics ours)—Regulations No. 45, Art. 1547.

The propriety of this method of calculation of profit on a sale of dividend shares, or on a sale of the original shares on which the stock dividend was declared, has recently been expressly affirmed by Judge Learned Hand in the Southern District of New York.

*Towne vs. McElligott*, 274 Fed. 960.

In that case, the taxpayer had sold the original shares on which the stock dividend was declared, and contended that in calculating his profit there should be deducted from the purchase price the whole of the price originally paid by him for those shares, leaving zero as the cost of the dividend shares; whereas the Government successfully contended that there should be deducted only the average between the price paid by the taxpayer for the original shares and the price paid—i. e., zero—for the dividend shares.

Judge Hand said:

"The second point is raised by *Eisner vs. Macomber*, 252 U. S. 189, and must be ruled by its implications. Under the doctrine of that case a stock dividend is not regarded as new property at all. The old certificate represents precisely the same property as the old and new do thereafter. The old shares have proliferated, as it were, and although the right they represented has now suffered a cellular division into smaller units of greater number, that is all that has happened. In view of this, it seems to me difficult to avoid regarding the old and new shares together as anything more than the evidence of a right which has persisted unchanged through the declaration of the dividend. It might have been possible to look at the new shares as declared from the surplus, and the surplus as not included in the old shares (at least not in the same sense as the new shares comprise it); but all such notions are expressly repudiated in the prevailing opinion. If so, each of the new shares, whether contained in the old or the new certificate, represents a part of the original property purchased and in selling the first certificate the stockholder has not sold the whole of what he originally bought, and should not be credited with the whole purchase price." (274 Fed. 962.)

This decision, it will be observed, was in favor of the Government, and we understand that the taxpayer has acquiesced in its correctness, notwithstanding that a very large amount of money was involved.

We may take it, therefore, as conceded, or at least as established, that upon a sale of stock which was issued as a stock dividend the cost to the taxpayer of the dividend shares is not to be taken as zero, but is to be calculated by dividing the price originally paid for the shares on which the stock dividend was declared by the total number of old and new shares, or in other words, by averaging the cost to the taxpayer of the old and new shares.

If this be law, then it follows inevitably that where a corporation, instead of declaring a technical stock dividend, increases its capital and offers the new shares to the old stockholders *pro rata* at less than the price which the new shares will be worth in the market, the stockholder who subscribes to his quota of new shares and subsequently sells them is not required to pay income tax *on the whole excess* of the price received for the new shares over the subscription price thereof, but should rather average the cost of the old and new shares and deduct this average from the price per share received for the new shares.

Judge Rose's reasoning on this point is cogent:

"The plaintiff, in the right of every share it held, and which had cost it, as just mentioned, \$710, could by paying \$150 a share more get another, so that it could have two, which in the aggregate would have cost it \$860, or \$430 apiece. There would be no way of distinguishing between the old and the new. If the latter were something which had not before existed, almost the same might as truthfully be said of the former. Its characteristics had undergone a great change. Before the issue of the new stock it represented one twenty-thousandth of the capital of the company; afterwards it stood for but one forty-thousandth. Moreover, if the

plaintiff had in person taken the new stock and had had its old and new consolidated into one certificate and had subsequently sold a part of its holdings, it could not say that that with which it parted was out of the old or out of the new or partly out of both. In determining its cost for the calculation of the gain or loss upon resale, it would be necessary to assume that they had, one and all, cost the holder an equal sum, which in the case of the plaintiff here was \$430 per share" (R. 7-8).

Consequently, if the plaintiff, instead of selling its "rights," had exercised them by paying \$150 per share for the 35 new shares to which it was entitled, and had immediately after sold the new shares for \$12,546.80 in excess of the \$5,250.00 it had paid on them, the profit would undoubtedly have been calculated by averaging the cost of the old and new shares,

### (C)

#### *Case Where the Stockholder Sells His Subscription Rights.*

If it be law, as we believe we have above demonstrated it to be, that a stockholder sells his quota of new shares after having subscribed and paid for them, should be taxed not upon the excess of the proceeds of sale over the cash paid to the corporation upon them, but on the excess over the average of that cash and of the cost of his old shares, then it necessarily follows that a stockholder who sells his pre-emptive right to subscribe to the new shares, instead of first subscribing and then selling, should not be taxed on the whole proceeds of sale. As said by Judge Rose in the Court below:

"It certainly could make no difference that, without waiting until the stock was issued and then selling it, it"—*i. e.*, the plaintiff—"sold the right to the new stock and made it part of the condition that the buyer should assume for it the payment of the \$150 per share exacted by the company" (R. 8).

If there is any error in this conclusion, it is an error in favor of the Government, as can be seen by reasoning the matter out on principle. A stockholder who sells his pre-emptive right of subscription to his quota of new shares has sold a part of his fractional interest in the company previously represented by his old shares. He has not merely sold his right to get a part of the new capital of the company, but what he retains no longer represents the same proportion of the existing assets of the company.

The decisions of this Court in the Stock Dividend Cases settled that a stockholder's interest is a fractional interest in the corporation, and that its real nature is independent of any change in its nominal or par value, or in the number of shares into which it is divided, so long as it represents the same fraction of the total stock in the corporation outstanding.

Conversely, those cases settled that a diminution, by action of the stockholder, in his fractional interest in the total capital stock outstanding, constitutes a diminution in the amount of his capital interest, even though there be no change in the nominal or par value of his holdings, or in the number of shares into which they are divided, or in the certificate or scrap of paper which is the muniment of his title; for this Court has clearly declared that a sale by a stock-

holder of new shares issued to him as a stock dividend is a sale of part of his original capital, so that it would necessarily follow that the whole proceeds of such a sale could not be income. Mr. Justice Pitney, delivering the opinion of this Court, said:

"If a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company is likewise diminished."

Eisner vs. Macomber, 252 U. S. 189, 212.

This declaration was more than a mere *obiter dictum*: it was the very *ratio decidendi* of the case. As already mentioned, the same rule has been judicially upheld in a recent decision of Judge Learned Hand in the Southern District of New York. See *supra*, pp. 12-3.

The Supreme Court of Connecticut, in a case between tenant for life and remaindermen, with reference to proceeds of sale of subscription rights, anticipated the very argument of this Court in the Stock Dividend Cases. After referring to previous decisions establishing the underlying principle, the Connecticut Court said:

"That principle is that until there has been some action by a corporation setting apart from the body of its assets some portion of them to become the property of its stockholders, and thus to pass out of the dominion of the corporation into that of the stockholders, there is nothing in existence to which the right of the latter can attach otherwise than as it attaches to the corporate in-

terest as a whole—nothing which can as to them be regarded as partaking of the nature of profits from the corporate investment.”

Boardman vs. Mansfield, 66 Atl. 169, 171; 79 Conn. 634, 639-640.

Applying this principle to issues of new stock, subscription rights were assimilated to stock dividends:

“Applying this principle to situations where new stock is issued and the right to subscribe therefor is accorded to shareowners *pro rata*, whether that issue be based solely upon surplus assets thus capitalized or upon surplus assets in part and payments by subscribers in part, or wholly upon subscription payments, we find that it is always true that no asset of the corporation is set apart to become the shareowners’. The corporation parts with nothing. The shareowner gets nothing which was before a part of the corporate property. He not only gets nothing in the way of tangible property, but he gets nothing in the way of intangible value. All that he acquires is some evidence of his ownership in the corporation, for which he perhaps pays more or less, or perhaps pays nothing” (66 Atl. 171; 79 Conn. 640).

Further on in the opinion, the same learned Court said:

“If he exercises his right to subscribe for his *pro rata* share, and pursuant to the terms of that right pays into the corporation the full par value of his subscription or some lesser sum supplementing a part payment from surplus assets thus capitalized, the result is again the ownership of more shares than before, but his total ownership represented by them forms a no greater proportion of the corporate assets than he formerly held, and those assets are precisely what they were, save as they

have been increased by the subscription payments to which he has made his proportionate contribution. If the true book value of the stock before the increase was more than par, that value after the increase becomes diminished by the fact that the surplus assets, which are incapable of appreciation, have to be distributed over a larger amount of outstanding stock. So if, instead of exercising his right to subscribe, the stockholder sells it for its true value, and his assignee steps into his place, the seller will, indeed, when the transaction has been closed, find himself with a sum of money in his pocket which he can call his own, but the certificate of stock which has remained in his strong box while bearing the same figures as formerly will represent as much less of true value as is measured by the money received" (79 Conn. 640-641).

Consider for a moment the now not uncommon case of stock without nominal or par value. Here each share of stock, in name as in fact, is simply a fractional interest in the company. If the stock of this insurance company had had no par value, the certificate issued to the Defendant in Error would or might have stated simply that the Defendant in Error was entitled to a 35 twenty-thousandths interest in the stock of company. After the increase in the capital, and the sale by the Defendant in Error of its subscription rights, there would have been a necessity of issuing a new certificate to the Defendant in Error stating it to be the owner of 35 forty-thousandths of the stock of the company—in other words, just half as much as before—exactly the same procedure as would have been required if the Defendant in Error had sold half of its original shares.



(D)

*Subscription Rights Are Not a Mere Privilege.*

The preferential right to subscribe to new shares is not a mere windfall but a right necessary to the preservation of the stockholder's quantum of interest in the corporation. If he sells, or fails to exercise, that right, the quantum of his interest is necessarily diminished.

As Judge Rose pointed out in the Court below, the Defendant in Error, before the increase of capital by the Hartford Fire Insurance Company, owned 35 *twenty-thousandths* of the company, and after the new shares were issued it owned, having assigned its preferential right of *pro rata* subscription, only 35 *forty-thousandths* of the company (R. 8).

Therefore, according to all the authorities, the preferential right to preserve one's proportionate interest in the corporation, by subscribing to a quota of any new shares, is inherent in ownership of stock, and cannot be defeated by the corporation.

The amendment to the charter of the Hartford Fire Insurance Company made by Act of the Legislature of Connecticut passed June 8, 1865, authorizing an increase in its capital stock, expressly declares:

"Each person who may be a stockholder at the time or times when such addition or additions shall be made shall be entitled to a *pro rata* share of said addition to the capital stock, to be subscribed for or taken by them under and in pursuance of such regulations as may be adopted by the directors."

Private Acts of Connecticut of 1865, p. 81  
 (which by agreement, R. 11, may be read  
 from the printed volume with the same ef-  
 fect as if a duly certified copy had been of-  
 fered in evidence).

Under this Act the capital stock was limited to 30,000 shares of \$100 each. In 1913, when only 20,000 out of the total of 30,000 shares authorized by the Act of 1865 were outstanding (R. 11), the Legislature of Connecticut by a new amendatory act authorized the company to increase its stock to an amount not exceeding in the aggregate \$10,000,000, or, in other words, 100,000 shares of \$100 each (Special Acts of Conn. of 1913, p. 773). The increase with which we are concerned in this case, from 20,000 shares to 40,000 shares, was therefore based in part upon the Act of 1865, and in part upon the Act of 1913. The Act of 1913 did not, like the Act of 1865, expressly provide that each stockholder should have a prior right to subscribe to his quota of the new stock before selling the same to outsiders; but it did not negative that right, and under the uniform course of judicial decisions the right inhered in the original shares just as if conferred by express statute.

Real Estate Trust Co., vs. Bird, 90 Md. 229;  
 Gray vs. Portland Bank, 3 Mass. 364;  
 Jones vs. Concord, etc., R. R. Co., 67 N. H. 119;  
 38 Atl. 120;  
 Eidman vs. Bowman, 58 Ill. 444;  
 Humboldt Driv. Pk. Ass'n. vs. Stevens, 34 Neb.  
 528; 52 N. W. 568;  
 Jones vs. Morrison, 31 Minn. 140, 151-3; 16  
 N. W. 854, 860-1;  
 State ex rel. Page vs. Smith, 48 Vt. 266, 289;

- Hammond vs. Edison Ill. Co., 90 N. W. 1040;  
 131 Mich. 79;  
 Electric Co. vs. Edison El. Co., 200 Pa. 516;  
 50 Atl. 164;  
 Wall vs. Utah Copper Co., 62 Atl. 533; 70 N.  
 J. Eq. 17;  
 Way vs. Am. Grease Co., 47 Atl. 44; 60 N. J.  
 Eq. 263;  
 Stokes vs. Continental Trust Co., 186 N. Y.  
 285, 239; 78 N. E. 1090;  
 2 Clark & Marshall on Corps., Sec. 408, p. 1290;  
 4 Thompson on Corps., 2 Ed., Sec. 3642;  
 5 Fletcher's Enc. of Corps., Sec. 3462, pp.  
 5696-8;  
 14 Corp. Jur., p. 395, tit. "Corporations";  
 1 Morawetz on Private Corporations, 2d ed.,  
 Sec. 455, p. —.

As said by the Supreme Court of Massachusetts:

"The right or privilege to take new shares in a corporation upon an increase of the capital stock within the limits fixed by the charter is a benefit or interest which attaches to the stock, not as a profit or income derived from the prosecution of the corporate business, but as an inherent in the shares from their very nature."

Atkins vs. Albree, 12 Allen (Mass.), 359, 362.

(E)

### *Decisions as to Tenants for Life and Remaindermen.*

Moreover, it has been held with almost entire unanimity that, where stock is held for life with remainder over, or in trust to pay the income to one person for life and after his death to transfer the corpus to another, the stockholder's

preferential right of subscription to new shares, or the proceeds of sale thereof, even when the value thereof is due to profits earned during the estate for life, should be treated, as between tenant for life and remaindermen, as principal and not income. The cases in which this conclusion has been reached deal with deeds or wills using in some cases the very language of the Sixteenth Amendment, and in some cases almost the same words as the "interest, rent, dividends, \* \* \* gains or profits, and income" used in the Revenue Act of 1918, approved February 24, 1919. The following is a list of some of the authorities holding proceeds of sale of subscription rights to be principal as between tenant for life and remaindermen, the exact language of the deed or will in question being quoted in each case wherever practicable:

Sanders vs. Bromley, 55 L. T. n. s. 145 ("wife to receive the *rents, issues and profits and dividends* thereof during her life");

Atkins vs. Albee, 12 Allen (Mass.) 359 ("the *income* thereof to be paid over by said Trustee from time to time, etc., etc., to my said wife during her life");

Re Kernochan, 104 N. Y. 618, 630; 11 N. E. 149 ("to apply the net amounts of such *rents and income* to the use of 'testator's widow'");

Biddle's Appeal, 99 Pa. St. 278 ("in trust to collect and receive the *income and interest* thereof for her own use during her life");

Moss' Appeal, 83 Pa. St. 264 "the *income, profits and products* of the estate" to go to wife for life);

- Walker vs. Walker, 68 N. H. 407; 39 Atl. 432  
("the *use and income*" to defendant for life);
- Peirce vs. Burroughs, 58 N. H. 302, 303 (exact language of will not stated in report);
- Boardman vs. Mansfield, 79 Conn. 634; 66 Atl. 169 ("the *dividends, rents and profits* to go to my beloved wife to her sole and separate use during her natural life");
- Hite vs. Hite, 93 Ky. 257, 267-8; 20 S. W. 778  
("to pay over the *net income* arising from said general trust estate to my wife," etc., "for life");
- Greene vs. Smith, 17 R. I. 28; 19 Atl. 1081 ("to pay monthly to said E. R. S. such part of the remainder of said *rents and income*");
- Brinley vs. Grou, 50 Conn. 66 ("the *rents, dividends, increase and income* thereof" to be paid to the tenants for life);
- DeKoven vs. Alsop, 205 Ill. 309, 319-20; 68 N. E. 930 ("to pay the *net income* thereof to" the testator's widow during her life);
- Robertson vs. DeBrulatour, 80 N. E. 938, 943; 188 N. Y. 301 ("to receive the *income and profits thereof*, apply the same to the use of my wife" during her life);
- Brown vs. Brown (N. J.), 65 Atl. 739 (exact language of will not set out);
- Curtis vs. Osborn, 65 Atl. 968; 79 Conn. 555  
(trust to pay "*net income*" to tenants for life—held shares bought by trustees in exercise of option are capital);

Hyde vs. Holmes, 84 N. E. 318; 198 Mass. 287  
(exact language of will not set out in  
opinion);

Eisner's Estate, 175 Pa. 143; 34 Atl. 577 ("to  
pay the net *income and interest* of the per-  
sonal estate" to the widow for life);

2 Clark & Marshall on Corps., Sec. 408, p. 1294;

5 Thompson on Corps., 2d Ed., Sec. 5398;

6 Fletcher's Enc. of Corps., Sec. 3724, pp.  
6192-4.

To be sure, some of these cases also hold that as between  
tenant for life and remaindermen a gain or profit realized  
upon a sale of capital assets by a non-trader is not to be  
treated as income, but rather as an increase in capital, where-  
as this Court has held that such "capital gains"—to borrow  
an expression from the new Revenue Law of 1921—are tax-  
able under the Sixteenth Amendment as "income." But  
we cite these cases, not as authority for the proposition that  
no part of the proceeds of sale of fixed capital assets can be  
"income"—for upon that proposition they are in conflict  
with the decisions of this Court in *Merchants L. & T. Co. vs*  
*Smietanka*, 13 Sup. Ct. 386, and *Walsh vs. Brewster*, 13  
Sup. Ct. 392, decided March 28, 1921, but for the proposi-  
tion that the proceeds of sale of a stockholder's pre-emptive  
right of subscription to new shares *are* proceeds of sale of  
capital assets. Upon *that* proposition, they are not in con-  
flict with any decision of this Court, but are rather supported  
by the decisions in *Tourne vs. Eisner*, 245 U. S. 418, and  
*Eisner vs. Macomber*, 252 U. S. 189,

And if such proceeds of sale are proceeds of sale of capital assets, they are certainly not *all income*; for although this Court has held that proceeds of sale of fixed capital assets may be *in part* a "capital gain" and therefore taxable "income," yet it has also held, in *Doyle vs. Mitchell Bros.*, 247 U. S. 179, 183-4, that the proceeds of sale of capital assets can never be *wholly income*.

## (F)

*Tax Commissioner vs. Putnam*, 227 Mass. 522.

It is true that a majority of the Supreme Court of Massachusetts has held that under the income-tax law of that State proceeds of sale of a stockholder's right to subscribe to his quota of new shares are taxable income.

Trefry, Tax Commissioner, vs. Putnam, 116 N. E. 904; 227 Mass. 522.

The Massachusetts Court, however, in the same case held that stock dividends are taxable as income under the Massachusetts law, and, as said by Judge Rose in the Court below:

"The express refusal of the Supreme Court of the United States to accept the ruling that stock dividends were[not] income necessarily deprives the Massachusetts case of persuasive force in the Federal Courts" (R. 7).

Indeed, no court has stated more clearly than the Supreme Court of Massachusetts the close connection between stock dividends and an option to subscribe to new shares of stock at less than their real value:

"An increase of capital by the corporation, which represents not only the amount then paid in, but also a value necessarily included in the capital because the stock is worth more than its par value, *is in the nature of a stock dividend* by the corporation to the amount of this additional value represented by the rights to subscribe" (italics ours).

Hyde vs. Holmes, 84 N. E. 318, 319-20; 198 Mass. 287, 293.

Moreover, the reasoning of the Massachusetts Court in *Treacy, Tax Commissioner, vs. Putnam, ubi supra*, in dealing with the question of proceeds of sale of rights to subscribe to new shares, is diametrically opposed to the reasoning of this Court in *Tourne vs. Eisner*, 245 U. S. 418, and *Hyde vs. Macomber*, 252 U. S. 189.<sup>1</sup> The Massachusetts Court said:

"Such rights are themselves a species of intangible property. They come to the stockholder as a gratuity. They are a new thing of value which he did not possess before" (116 N. E. 910; 227 Mass. 532).

Speaking of a stock dividend, the Massachusetts Supreme Court used almost identical language:

"It was the issuance to the stockholder of a new thing of value. \* \* \* It is a thing different in kind from the

<sup>1</sup>It is significant of the divergence of opinion between the two Courts that the Massachusetts Court disapproved *Lynch vs. Southern Ry. Co.*, 149 C. C. A. 649 (236 Fed. 653), and referred favorably to *Putnam vs. Pacific Ry. Co.*, 238 Fed. 847 (Trefry, Comm'r. vs. which 227 Mass. 522, 536; 116 N. E. 904, 912), whereas the former case, which was disapproved by the Massachusetts Court, has since been affirmed by this Court, *Lynch vs. Turrish*, 247 U. S. 221, while the decision which the Massachusetts Court regarded favorably, *Lowce*, has been reversed by this Court, *Southern Pac. Ry. Co. vs. Lowce*, 247 U. S. 330.



thing which the stockholder owned before. \* \* \* The thing of value which is taxed as income, namely the dividend in stock, did not come into his possession or right to possession until the year for which he is taxed" (116 N. E. 911-12; 227 Mass. 535, 536).

Set over against these passages the reasoning of this Court in the Stock Dividend Cases. For example:

"This, however,"—*i. e.*, a stock dividend—"is no more than a book adjustment, in essence not a dividend but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution."

Eisner vs. Macomber, 252 U. S. 189, 210.

Moreover, the Supreme Court of Massachusetts recognize that sales of subscription rights are sales of a part of the vendor's capital, and yet they pass silently over the inevitable conclusion that only a part at most of them can be taxable income:

"They are not regarded ordinarily as a profit from the prosecution of the business, but are an inherent and constituent part of the shares. \* \* \* *They are indistinguishable in principle from a sale of the stock itself, and gains derived from the sale of such rights fall within the same class of income*" (italics ours).

Trefry, Tax Commissioner, vs. Putnam, 227 Mass. 522, 534; 116 N. E. 911.

*Subscription Rights Different From Ordinary Options.*

The brief for Plaintiff in Error adverts to the fact that either the original stockholders or the purchasers of their "rights" could fail to exercise the subscription privilege.

If, however, this should be done, it would be because the rights were worth very little; and, therefore, in such a case the taxability *vel non* of the proceeds of their sale would be of little practical importance.

If a stockholder himself simply fails to exercise his preemptive right, there is of course no question of income.

If a stockholder sells his "rights" and the purchaser fails to subscribe to the new shares, the vendor is not in the same position as an ordinary property owner who has given an option of purchase which has not been exercised. In the latter case, the owner retains the property precisely as if no option had been given. But in case of a sale of subscription rights, even if the purchaser fails to exercise the subscription privilege the vendor's proportionate interest in the company has been diminished. If the other stockholders subscribe, this diminution is but little less in amount than if his immediate vendee had also done so. Even in the almost impossible contingency of *all* the stockholders failing to exercise the "rights," still the vendor of "rights" is not in the same position as before the sale; for the corporation is free to issue his quota to outsiders. He has parted irrevocably with the right to maintain his proportionate interest in the company.

But rights at all such questions are irrelevant. The subscription shares in the case at bar were worth more than \$350 per share, and nobody claims that any of such valuable rights were allowed to lapse. Judge Rose, who was sitting as a jury, found that after the transaction was over each old share held by the plaintiff, instead of representing one-twenty-fourth of the capital of the company, "stood for but one-hundredth" (R. 7). It is bootless to confuse a clear and simple case by discussing how far if at all proceeds of sale would be taxable under entirely different circumstances.

## II.

### METHOD

#### OF CALCULATING PROFIT, IF ANY, ON SALE OF SUBSCRIPTION RIGHTS.

### Although

As repeatedly stated above, the only exception to the rule that the Plaintiff was not entitled to recover at all, holds that the judgment must be affirmed unless this Court holds that the whole proceeds of sale of the subscription rights constituted income and not capital, nevertheless, it is pertinent to consider the method or methods of calculating the amount of "capital gain," or taxable profit, if any, realized upon a sale of such subscription rights; for the Government contended below that no practicable rule can be

laid down for determining the amount of the capital gain realized upon the sale, and that therefore the only safe course is to tax the whole proceeds of sale as income and leave the diminution in the value of the original shares to be deducted as a loss, when, if ever, those original shares are sold.

The case, it was argued, was similar to a sale of mined minerals, where the whole proceeds of sale may be taxed as income, although technically the mining operations deplete the minerals in the soil, so that, in one sense, the products of the mine can be said to be part of the capital of the mine owner.

Stratton's Independence Ltd. vs. Howbert, 231 U. S. 399;

Von Baumbach vs. Sargent Land Co., 242 U. S. 503;

Stanton vs. Baltic Mining Cp., 240 U. S. 103.

These mining cases, however, depend on peculiar principles. Mined minerals are the product, in part, of the skill and labor of the mine owner, or his agents. Theoretically, the mine owner's right extends to the centre of the earth; and however valuable the mined minerals may be, they represent only an infinitesimal fraction of the total minerals in the portion of the earth to which the mine owner is entitled. Consequently, minerals produced from a mine existing at the creation of an estate for life have always been regarded as income to the same extent as crops.

Coke on Littleton, 54 b;

1 Tiffany on Real Property, 2d Ed., Sec. 282, p. 956;

21 Corpus Juris, pp. 947-8, tit. "Estates."

The case at bar is very different, however. The Defendant in Error has sold a half of its fractional interest in the Hartford Fire Insurance Company. It has sold part of the rights which constituted the capital of its ward's estate. In reality it is no more difficult to determine how much of the total original value of the ward's capital was represented by the rights which the Defendant in Error has sold, than it is in many cases where part of a property has been sold to determine how much of the original cost is to be allocated to the portion sold.

For instance, A buys 1,000 acres of land varying greatly in value, for a lump sum. A portion of the land lies, we will say, on the outskirts of a thriving city, another portion on the waterfront with valuable riparian rights, a portion is farming land, while some of the rear portion is arid and unfit for use even for farming. A then sells one acre. To determine whether he has realized a profit or a loss upon the sale is extremely difficult, because it is extremely difficult to determine how much of the purchase price was to be allocated to the acre re-sold. Yet, who would contend that on account of this difficulty the whole price received for one acre on the resale should be treated as income?

Again, B buys a tract of land, and afterwards for a consideration grants to A and his heirs an easement or right of way over it. He has thus parted forever with some of the rights of ownership in the land which he originally bought; yet it is extremely difficult, to say the least, to determine how much of the original purchase price should be allocated to the right-of-way which he subsequently sells to his neighbor. Yet who would contend that on account of

that difficulty the whole proceeds of sale of the right-of-way should be treated as income?

Indeed, in the present case the difficulty of determining the original cost to the taxpayer of the thing which he has sold is less than in the hypothetical cases we have just put; for in the present case the *maximum* profit to the stockholders on the sale of the rights can be worked out *mathematically*.

To make the matter clear, suppose the corporate entity be disregarded and the stockholders treated as if they were co-owners of the corporate property. We should have a case substantially like the following: A and B purchase a lot of ground for \$100,000, and take title in undivided moieties as tenants in common. They determine to improve the land by a building costing \$20,000, and agree that each shall either contribute \$10,000 towards its cost or sell to an outsider the right to acquire one-half of the vendor's moiety by paying \$10,000, towards the cost of the new building, into the common till. A contributes his \$10,000 himself, but B sells to C <sup>for \$35,000</sup> the right to acquire a half of B's moiety by paying \$10,000 towards the cost of the new building. After the transaction is over, B, instead of owning an undivided half interest in the property, owns an undivided fourth interest. Surely, therefore, the whole \$35,000 he has received could not be treated as income.

The truth is, that, in the case we have just put, B sells half of his moiety and he receives therefor \$35,000 in cash plus his share of the increment in the value of the land due to the new building. After the transaction is over B has a fourth interest in property which cost \$120,000—i. e., the

original \$100,000 plus \$20,000 expended on the new building. He has sold a half of his moiety, which cost him \$25,000. He has received for it \$35,000 in cash, and the value of the land has been increased by the new building.

The only real question in such a case, we submit, is whether B, in calculating his profit upon the sale of half of his moiety to C, should be charged with the increase in the value of his remaining fourth interest, or whether that should be treated as an unrealized increment in value, which is not to be considered for the income tax purposes until actually realized by sale.

To translate the symbolical case we have just put, into terms of the actual case before us, we have the following: The Defendant in Error held a 35 twenty-thousandths interest in the Hartford Fire Insurance Company, costing it 35 times \$710, or \$24,850. It sells half of this interest for \$12,546.80. If you disregard the fact that the Defendant in Error, by reason of its ownership of the 35 shares of the original stock, will be entitled indirectly to participate in the new capital paid into the corporation not only by the purchaser of its subscription rights but also by other subscribers, the taxable profit of the Defendant in Error on the transaction is the difference between \$12,546.80 and one-half of \$24,850.00, that is to say, \$121.80. If, however, you bear in mind that the corporation has received \$150 a share for 20,000 shares—*i. e.*, \$3,000,000—and that 35 forty-thousandths of this new money inures to the benefit of the Defendant in Error as the owner of its original 35 shares, its profit on the transaction will be increased by \$2,625, that is to say, the Defendant in Error's profit would be \$121.80, plus \$2,625, or \$2,746.80.

This is exactly the result reached by the Court below (R. 8). Judge Rose said:

"If \$78.40 be multiplied by 35, the number of shares or rights sold by the Plaintiff, the product will be \$2,746.80, and upon that it was properly taxable and upon nothing more" (R. 8).

The difference between Judge Rose's method of calculating the profit on the sale of the rights, and the method last stated above, is merely one of words, as applied to the facts of this case.

We submit that this method is, if anything, too favorable to the Government, because it treats the sum of \$150 per share paid to the corporation by the purchaser of the Defendant in Error's subscription rights as if it had been paid to the Defendant in Error. In point of fact it was paid to the corporation, and the increased value of the Defendant in Error's original shares, due to the new capital acquired by the corporation from the old stockholders and their assignees upon the increase of stock, is not yet severed from those shares and should not be taxed until realized by sale.

In other words, we submit that the true method of calculating the tax is as follows: The original 35 shares stood the Defendant in Error \$710 per share, or \$24,850. It has sold one-half of this interest, because it retains only 35 forty-thousandths of the capital stock of the company instead of the 35 twenty-thousandths which it originally acquired. Therefore, the cost of the interest sold is to be taken as one-half of ~~\$24~~,850, or \$12,425. The proceeds of sale are \$12,546.80. The taxable profit is the difference between the two, or only \$121.80.



Of course, no mathematical formula for calculating the profit will work out absolutely accurate results. For one thing, the price of a block of stock is not always the market price of one share multiplied by the number of shares in the block. Fifty-two per cent. of the capital stock may be worth more than twice as much as twenty-six per cent. Moreover, Judge Rose's method assumes, in favor of the Government, that each share of stock is increased in value by its proportion of the new capital derived by the company from the increase of its capital stock.

Perhaps the precise method of calculating the profit could safely be left to the Regulations of the Treasury Department; but such regulations, in order to be valid, must be based upon the correct legal theory, namely, that the subscription rights are not income, but are part of the stockholder's original capital.

At all events, at the present time it is unnecessary for this Court to decide what is the correct method of calculating the profit on a sale of the subscription rights. The decision of the present case is controlled by the fact that certainly a part of the proceeds of sale were capital, and not income, of the Defendant in Error's ward, so that the Defendant in Error was entitled to recover something.

### III.

#### CONSEQUENCES OF ALLEGED IMPOSSIBILITY OF DETERMINING AMOUNT, IF ANY, OF PROFIT ON SALE OF SUBSCRIPTION RIGHTS.

We have endeavored to show above that it is not impossible to calculate the profit, if any, realized on a sale of subscription rights, and that it is no more impossible to segre-

gate capital from income in such proceeds of sale than in proceeds of other sales of portions of property acquired as an entirety. But if such impossibility were conceded, what would be the result?

Would the result be that the whole proceeds of sale should be taxed, or rather that no part should be taxed?

If capital and income be inextricably blended in a certain fund without fault upon the part of the owner, and if the law taxes only so much as is income, and the taxing authority is unable to show that any particular amount of such proceeds is income, then the inevitable conclusion would seem to be that *no tax* could be levied. Freedom is still the normal condition of an American citizen; and if the Government undertakes to tax him, it must show clearly that he comes within the terms of the taxing statute.

Of course, in a suit like the present the burden of proof is on the Plaintiff; but when he shows that the law taxes nothing but income, and that a tax has been levied on a fund which represents a mere conversion of capital assets, and is certainly capital in part and which the Government is unable to show is not capital *in toto*, then the burden of proof is shifted.

Indeed the Treasury recognizes, in other cases, that where a part of property purchased as an entirety is sold, and it is impossible to apportion the original consideration, so as to ascertain the cost of the part or right sold, then no taxable income is deemed to accrue until the taxpayer has recouped the full original cost of the whole property. The Regulations provide:

"Where common stock is received as a bonus with the purchase of preferred stock or bonds, the total purchase price shall be fairly apportioned between such

common stock and the securities purchased, for the purpose of determining the portion of the cost attributable to each class of stock or securities, *but if that should be impracticable, in any case, no profit on any subsequent sale of any part of the stock or securities will be realized until out of the proceeds of sales shall have been recovered the total cost*" (italics ours).

Regulations No. 45, Revised, Art. 39.

And again:

"If property is exchanged for two different kinds of property, such as bonds and stock, not having a fair market value, the cost of the original property shall be apportioned, if possible, between the bonds and stock for the purpose of determining gain or loss on subsequent sales. *If no fair apportionment is practicable, no profit on any subsequent sale of any part of the bonds or stock is realized until out of the proceeds of the sales shall have been recovered the entire cost of the original property*" (italics ours).

Regulations No. 45, Revised, Art. 1565.

By applying a similar rule, substantial justice would be accomplished in case of sales of stock subscription rights. The result would be simply that the prices realized for the subscription rights would be charged against the cost of the original shares. If hereafter the original shares should be sold, the price realized for them would have to be added to the price realized for the subscription rights, and from the total the original cost of the shares would be deducted. The difference, if any, would be taxable income for that year.

Whether this conclusion should be reached, or whether the courts should endeavor to calculate how much of the original

cost of the old shares should be allocated to the rights sold, and deduct the portion thus allocated from the proceeds of sale of the subscription rights, the residue or excess being taxable income, is a question which seems to us to depend on what the attitude of the Court is to be towards the larger question of how profits are to be calculated where the taxpayer has sold a portion of a large bundle of rights acquired by him at one time and at a lump price. If in such a case this Court shall hold that the taxpayer must endeavor to apportion the original consideration as best he can, we can see no reason why the same thing should not be done upon a sale of subscription rights, which are a part of the stockholder's original capital. On the other hand, if this Court shall hold that where it is difficult to apportion the original consideration, the amount realized upon a sale of part should simply be credited against the original cost of the whole, no taxable profit being realized until the whole has been sold, then we can see no reason why the same course should not be followed here.

To take an illustration already used once before: If a man buys a lot of ground for \$10,000 and sells his neighbor a right-of-way across it for \$500, it is extremely difficult to say whether he has realized a profit or a loss. It may be, the existence of the right-of-way would be such a prejudicial encumbrance that the land subject to the right-of-way will not sell for as much as \$9,500. On the other hand, perhaps the land subject to the right-of-way is worth almost as much as if it had remained unencumbered. In the former case, there would be no profit, but rather a loss on the sale of the right-of-way, whereas in the latter case a large part of the \$500 would be clear gain. If on such facts this Court would

hold that you must endeavor to apportion the original price of \$10,000 and ascertain how much was attributable to the rights comprised in the right-of-way, and how much to the remaining rights inherent in ownership, then we should think that a similar course should be followed here. If, on the other hand, the courts would hold in the case of a sale by a landowner of a right-of-way that the amount realized should simply be credited against the original cost of the land, no taxable profit being realized until the completion of the transaction by a sale of the land itself, then we should think that a similar course should be followed here.

At all events, it is sufficient for a disposition of the present case in this Court that in no event would it be possible to regard the whole proceeds of sale of the right-of-way as taxable income.

#### IV.

#### **DISTINCTION BETWEEN THE CONSTITUTIONAL AND STATUTORY QUESTIONS INVOLVED.**

If a stockholder's right of subscription to his quota of new shares upon an increase of stock by the corporation constitutes, as we contend it does, a part of his original capital, then we submit with confidence that any Act of Congress taxing as income the whole of such proceeds of sale without apportionment between the States would be unconstitutional.

If the Plaintiff in Error is right in his construction of the Revenue Act of 1918, then we submit with confidence that the Act is an unapportioned direct tax on capital and therefore unconstitutional.

*Eisner vs. Macomber*, 252 U. S. 189, 217-19.

In order to reverse the judgment, this Court must pass both upon the statutory and constitutional questions; but in order to affirm, it is only necessary to decide that the Revenue Act of 1918 does not undertake to tax the whole proceeds of sale of a stockholder's subscription rights as if they were income. That Act did in terms attempt to tax stock dividends as income, and in that particular was held unconstitutional by this Court.

*Eisner vs. Macomber*, 252 U. S. 189.

But as to stock subscription rights, there is no such express provision. If taxable at all, they are taxable under the general words in the Act taxing "gains, profits and income derived from \* \* \* commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rents, dividends, securities \* \* \* or gains or profits, and income derived from any source whatever." Act approved Feb. 24, 1919, c. 18, 40 Stat. 1065.

While a difference of opinion existed among the members of this Court as to the constitutionality of the express provision in the Revenue Act of 1918 attempting to tax stock dividends as income, yet the Court had unanimously held that the general words in the Income Tax Law approved October 3, 1913 (c. 16, 38 Stat. 167), which were identical with the general words above quoted from the Revenue Act of 1918, should not be construed to tax a stock dividend.

*Towne vs. Eisner*, 245 U. S. 418.

We submit that there is no more reason for holding that the general words in the Act of 1918 should be construed to

tax as income the stockholder's right to subscribe to his quota of new shares, or the whole of the proceeds of sale thereof, than for holding that those same general words should be construed as taxing a stock dividend.

## V.

### INJUSTICE OF TAXING SUBSCRIPTION RIGHTS AS INCOME.

While the most equitable of tax laws will sometimes work injustice, the fact that a given construction will frequently, and indeed as a rule, cause great injustice, tends to show that the construction is erroneous.

Take the present case as an illustration. The baby for whom the defendant-in-error is guardian inherited from his father property yielding a net annual income, properly so-called, too small to be taxable. The chief assets seems to be the 35 shares of the Hartford Fire Insurance Company worth \$710 per share, or \$24,850. By the sale of the subscription rights, the value of this infant's holdings of this stock shrank to about \$515 per share (R. 12), or \$18,025. In other words, this Court is asked to say that because the defendant-in-error received \$12,546.80 for something, parting with which caused a loss of the difference between \$24,850 and \$18,025, or \$6,825, therefore a tax should be paid on the whole \$12,546.80 as though it were income.

Of course, the fact of decrease in the market value of the old shares is not in itself controlling.

United States vs. Phellis, decided November 21, 1921.

But the decline in market price, while not controlling in itself, is significant as one indication of the mathematical

fact that the Defendant in Error had sold part of the interest formerly represented by its certificate for 35 shares. Not the fact but the cause of the decline in market price is important.

In the Phellis case this Court was careful to point out that the stock of the new company distributed as a dividend to the stockholders of the old company might be sold by one of the latter *without affecting his proportionate interest* in the old company:

"He could sell his entire portion, or any of it, without parting with his capital interest in the parent company, or affecting his proportionate relation to the interests of other stockholders."

The mere fact of an increase of stock, offer of new shares *pro rata* to the old stockholders, and a sale of the subscription rights, *in and of itself has no tendency* to produce any profit or loss to any one who acquired his stock at the actual value prevailing before the increase; and if market values always reflected actual values, both in the case of subscription rights and in the case of shares of stock, a sale of subscription rights would never produce profit or loss to such a person.

For example, if the price of \$710 per share, the cost of the defendant-in-error of its 35 shares, reflected actual values, the company's balance sheet, prior to the increase of stock, would show the following net assets:

Capital Stock (20,000 shares).....	\$2,000,000
Surplus. ....	12,200,000
	<hr/>
Total.....	\$14,200,000
	<hr/>
Book value per share.....	\$710



After the increase of stock the balance sheet would show the following:

Capital Stock (40,000 shares).....	\$4,000,000
Surplus:	
Old Surplus .....	\$12,200,000
Premium on issue of new shares.....	1,000,000
	<hr/> 13,200,000
<b>Total.</b> . . . . .	<hr/> \$17,200,000
 Book value per share.....	 \$430

The defendant-in-error by its sale, therefore, transferred to the purchaser the right to get shares worth \$430 each for \$150 each. The difference, or \$280, represented the value of the rights per share.

If, therefore, the defendant-in-error had sold its subscription rights for \$280 per share, it would have had exactly the same in value after the completion of the transaction as before it started, as shown by the following:

#### VALUE OF DEFENDANT-IN-ERROR'S INVESTMENT BEFORE INCREASE.

35 shares at \$710 per share.....	\$24,850
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#### VALUE OF DEFENDANT-IN-ERROR'S INVESTMENT AFTER INCREASE.

35 shares at \$430 per share.....	\$15,050
Proceeds of sale of subscription rights (35x280).....	9,800
	<hr/>
<b>Total.</b> .....	\$24,850

In fact, defendant-in-error sold its rights for \$358.48 per share. The increase may be accounted for by general market conditions and perhaps in part by the fact that an is-

suance of subscription rights is sometimes thought by the public to foreshadow the payment of dividends on the new stock at the same rate as previously paid on the old, just as the declaration of a stock dividend is sometimes thought to presage the maintenance of the dividend rate upon the new shares. In both instances, however, the public is speculating on the intention of the directors. A mere resolution passed by the board expressing an intention to increase the regular dividends would have the same bullish effect. Indeed, we are told—though the Record does not disclose it—that the directors in this case actually did pass some such resolution. But whether they did or not, no property passed from the control of the corporation to the control of the several stockholders.

In either case, if the stockholder takes advantage of the rise in the market, he may perhaps be charged with taxable income *to the extent of that rise*, but certainly not upon the whole proceeds of sale.

Consequently, we submit that the District Court properly refused to direct a verdict for the defendant.

Respectfully submitted,

ARTHUR W. MACHEN, JR.,  
*For Defendant-in-Error.*

HERSHEY, MACHEN, DONALDSON & WILLIAMS,  
*Of Counsel.*



DEC 5 1921

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# Supreme Court of the United States

OCTOBER TERM, 1921.

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**No. 416**

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**JOSHUA W. MILES,**

Collector of Internal Revenue for the District of Maryland,

*Plaintiff in Error,*

**VS.**

**THE SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE,**

Guardian of Frank R. Brown,

*Defendant in Error.*

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**BRIEF OF ARTHUR M. MARSH,**

filed as *amicus curiae*, and on behalf of DeVer H. Warner,

Trustee under the will of I. DeVer Warner, deceased.

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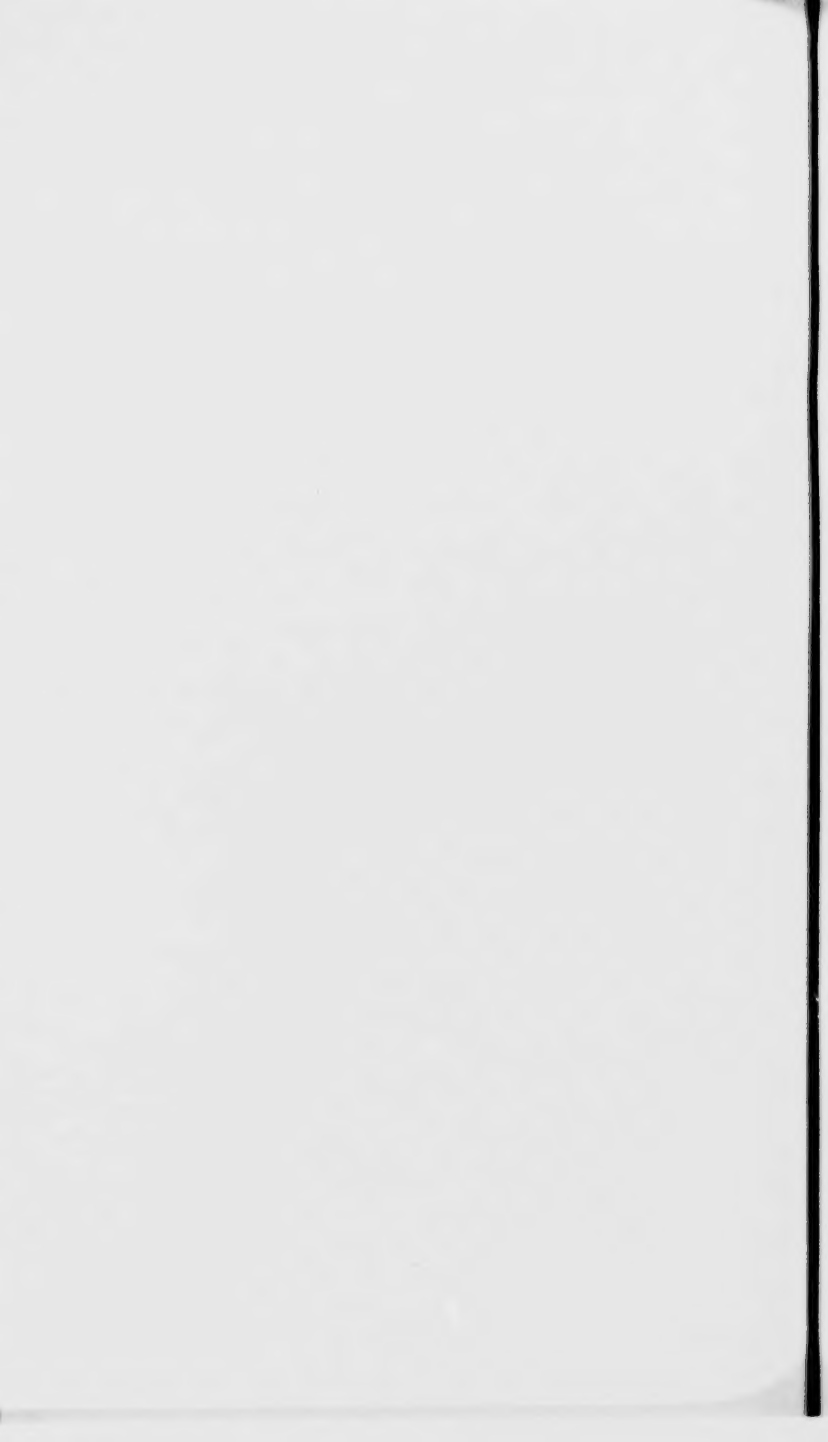


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**BRIEF OF ARTHUR M. MARSH, filed as *amicus curiae*, and on behalf of DeVer H. Warner, Trustee under the will of I. DeVer Warner, deceased.**

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## STATEMENT.

This brief, by permission of the Court, is filed by the undersigned as *amicus curiae* and on behalf of DeVer H. Warner of Bridgeport, Connecticut, trustee under the will of I. DeVer Warner, deceased.

The point in the case at bar is the taxability, as income, of the entire proceeds of sales of rights to subscribe for increased capital stock of a corporation, under the Sixteenth Amendment of the Constitution and the Acts of Congress passed pursuant thereto, particularly the Act approved February 24, 1919. The defendant in error received such proceeds as guardian of a minor.



The contention of the Government is that such proceeds, *in toto*, are income, and further that the cost of the original shares to the taxpayer is immaterial. The trial court held the proceeds not income, but taxable in part, on the facts of this case, as a gain or profit. Record, page 8.

The trustee represented by the undersigned is administering a trust under a will which directed the payment of the income of a trust fund to certain beneficiaries for life, with a bequest of the corpus to remaindermen. Upon an increase of the capital stock of a certain corporation, the trustee became entitled to subscribe for additional shares, part of which rights he exercised. The balance he sold, receiving as proceeds of sale approximately \$200,000.00, upon the basis of which, as taxable income to the full extent of such receipts, the said estate has been assessed by the United States. Pending the decision of the case at bar this assessment has been abated.

The question concerning said estate and the question in the case at bar are fundamentally the same, but the trustee, if there is any difference, should be in a more favorable position, the will under which he is acting providing different destinations for the income and the corpus of the trust fund. In Connection it is unquestionably the law that under such a will proceeds of sales of rights to subscribe belong *in toto* to the corpus or principal.

Boardman vs. Mansfield, 79 Conn., 634.

In the case of the Warner estate the increases of stock took place in 1916 and 1917, during the operation of the Acts of Congress concerning income taxation, approved September 8, 1916, and October 3, 1917, but it is believed that the decision of the case at bar will have a material bearing upon the determination of the controversy between the Treasury Department and the aforesaid trustee.

## OUTLINE OF ARGUMENT

1. Congress, by virtue of the Sixteenth Amendment, may tax income, but not principal, by direct taxation without apportionment; the Sixteenth Amendment did not *enlarge* the powers of Congress or *enable* it to tax income; it affected only the method of such taxation.

2. Congress, by labelling as income that which is really principal, cannot make it income. At all events, even if Congress may possibly have some latitude in deciding such a point with reference to receipts of which the character is debatable, it has not attempted to do so with reference to the receipts in question. This is true of all the income tax legislation since the Sixteenth Amendment, and the point gains added force from the fact that in that legislation certain other classes of receipts have been particularly specified and defined to be income. The assessment in the case at bar depends solely upon a Treasury ruling.

3. Receipts of money from sale of rights to subscribe for increased corporate stock are principal. Such rights from the very beginning of every corporation are an inherent and constituent part of the shares. The sale is a mere change in the form of the investment. By the issue of the rights there is no separation or distribution of anything from or out of the corporate assets into the individual dominion of the stockholders.

If this proposition is correct, we submit that it follows irresistibly from *Eisner vs. Macomber*, 252 U. S. 189, that the theory of the Government is untenable.

4. The decisions in cases involving this precise point, as between life tenant and remainderman, are substantially a unit in holding such proceeds of sale to be principal. This is naturally so in the jurisdictions which agree with this Court (*Gibbons vs. Mahon*, 136 U. S., 549) in holding stock dividends to belong

to the corpus of the fund. But it is also true in every one of those opposed, except New Hampshire, where there are decisions both ways.

5. The case of *Trefry, Tax Commissioner, vs. Putnam*, 227 Mass. 522, which is the only direct authority of which we are aware, was decided by a divided Court, turned upon the local effect of Massachusetts legislation, is far from convincing or persuasive in its reasoning, and with reference to stock dividends has been emphatically rejected by this Court.

*Eisner vs. Macomber, supra.*

6. If the proceeds of sales of rights are not "income", the taxation in question can rest only upon the terms "gains" or "profits", but no decision or ruling has held gains or profits taxable unless actually realized; and as the rights to subscribe are a constituent part of the shares, it is impossible, until the corresponding shares are also sold, to determine whether the aggregate amount realized from the rights and the shares results in a gain. None of the shares have been sold by the owner in the case at bar, nor by the trustee whom we represent.

7. In conclusion and in answer to opposing arguments.

Rights are represented by warrants which can be sold separately from the stock; true, but so likewise are stock dividends.

Rights are only valuable in case the corporation is prosperous and has a surplus over the par value of its shares issued and about to be issued; true, but none of those accumulated profits are "distributed" by the issue of the rights, and whether the rights are sold or exercised cannot affect that indisputable fact. No "income" can possibly result from corporate action unless assets are separated from the corporate treasury.

The market value of the shares falls upon the issue of rights, and likewise upon the declaration of a cash dividend, especially a large or extra cash dividend, and the latter is certainly income; granted, but the causes of such depreciation are radically different. In the former case the shares fall because the new shares will participate equally with them and thus dilute their value. In the latter case, they fall because the corporate treasury has been depleted by the actual departure of the cash used to pay the dividend.

### INCOME AND PRINCIPAL

In several of the earlier cases which arose after the Sixteenth Amendment, the Government made the broad contention that all receipts—everything that comes in—are “income” within the proper definition of the term “gross income”. This Court has thoroughly disposed of that contention in *Doyle vs. Mitchell Brothers Co.*, 247 U. S., 179, and *Southern Pacific Co. vs. Lowe*, 247 U. S. 330, and it is now settled that the nature of the receipts determines the point.

Without entering upon the refinements of definition, it must be clear that the intention of Congress, as well as its power, applies to income and not to principal. The terms themselves are mutually exclusive. Whether or not, since the Sixteenth Amendment, Congress can tax, and has taxed, the proceeds of sales of rights is dependent upon the nature of such proceeds. That the *powers* of Congress were not enlarged by the Sixteenth Amendment appears sufficiently from the *Brushaber* and *Baltic Mining* cases and need not be argued. The point of importance is that unless rights to subscribe or proceeds of sales thereof are in their nature income, Congress cannot tax them except by provision for apportionment.

Undoubtedly the issue of definition of income and principal has been most sharply and frequently raised in the life tenant and remainderman cases. Sales of rights have often figured in such litigation. The reasoning of those cases and the leading decisions on the point now in question ought, accordingly, to have great weight. In the discussion below, we believe we shall be able to demonstrate that so far as the life tenant cases are concerned, the state courts throughout the country, with one lone exception, are uniform in holding that the sale of rights constitutes merely a change in the form of principal and is in no sense income. As a matter of practical administration of the laws among the citizens of the country generally, it is submitted that if possible the legal definition of income ought to be identical for income tax purposes and for application to life tenants and remaindermen. "Income" is a term of reasonably settled meaning; it has been the subject of numerous decisions in the life tenant cases; officials and trustees are familiar with these decisions; and it is a source of much confusion and bewilderment to the tax payer to be told, as the Treasury ruling now in question tells him, that these receipts are not income in the sense that they can be distributed and enjoyed by the life tenant, but are, nevertheless, income so that they must be taxed as such, to somebody.

It would appear that the insistence of the Government on the Treasury ruling on this point may be a survival of its erroneous contention above mentioned and not yet entirely abandoned, viz., that all receipts are, as such, *prima facie* income.

### THE NATURE OF RIGHTS TO SUBSCRIBE

Whenever any corporation is formed, each stockholder has, as a matter of law and as a part of the fundamental compact be-

tween the stockholders themselves, the right to subscribe for his proportional part of any and all increases of the stock which may be made in future.

This right is one of the attributes of his ownership of the stock. It is inherent in his title to the stock as thoroughly as his right to vote upon it, and is indeed closely allied to that right, being based, of course, upon the principle that each stockholder has the right, in proportion to his stock ownership, to control the management of its affairs. If new stock could be issued by the majority of the stockholders without offering it to all alike in proportion to their holdings, this right to proportionate control would be diminished.

It is a right, so to speak, to *contribute* more capital to the corporate enterprise rather than to take anything out of the corporate treasury.

Accordingly it is not a new thing which arises, or is bestowed, or created, either by the prosperity of the corporation or by corporate action at the time of an increase of stock; it exists from the very beginning of every corporation, and is one of the constituent elements and attributes of the ownership of every share. So far is it from being a favor or privilege, or in any way within the control or discretion of the majority, that the holder of a single share could prevent by injunction an increase of stock which disregarded his rights in this particular. Rights are not *produced* by the capital investment; they exist whether the corporation is prosperous or not.

It is probable that the popular talk and thought of rights as representing some sort of a dividend or "distribution" by a corporation is based upon the fact that while the stockholder retains his certificate of stock the same as before, he also receives a warrant or similar instrument, which can be turned into money separately from the certificate. The same is true of an issue of

additional certificates by way of stock "dividend", so called, and in that case the popular error arises even more readily by reason of the term "dividend", which is a misnomer and a survival from the days of stock watering. It has often been the case also with prosperous corporations that the fall in market prices after an issue of rights, or a stock dividend, has been made up within a short time; but this is based upon the probably prosperous future of the corporation. There is no magic about the issue of rights, or of stock dividends, and it is impossible to get away from the fact that, in neither case, is there a single new, or different, dollar of value, either in the corporate treasury, or in the hands of the stockholder, however the number of certificates or other pieces of paper, which represent such value, may be increased.

For all these reasons, perhaps followed too far in elementary detail, it is truly said that the right to subscribe is a constituent part of the share itself. If the stockholder sells it he receives cash, but he severs an inherent part of the life of his share. His voting rights, his proportionate control, his inchoate right to participate in accumulated profits as well as in capital at liquidation, and every ~~other~~ right, are affected and diminished as much as if he had sold an undivided fractional interest in his share.

The whole structure of the title is cut vertically, so to speak, or from top to bottom, so that a part of every attribute, and of the value of every right inherent in ownership, has gone.

### **SALE OF RIGHTS IS A MERE CHANGE IN FORM OF THE INVESTMENT**

In cases of this kind a concrete example is often useful.

Suppose a corporation has assets on March 1, 1913, of \$250,000.00, its capital stock at par being \$100,000.00. Each

share of stock is, therefore, worth \$250.00. The corporation then decides to double the stock and to do so by subscription for new shares at par, or \$100,000.00.

As its former assets were	\$250,000.00
the amount paid in for the new shares will add	100,000.00

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so that its total assets after the increase will be \$350,000.00

The number of shares being then two thousand, instead of one thousand, each share will be worth \$175.00. A shareholder, holding one share of stock, which he bought for \$250.00, will therefore have invested \$350.00 if he exercises his right to take his additional share. If thereupon the corporation should be wound up, he would receive his \$350.00 in money and would have made neither gain or loss.

Suppose, on the other hand, he sells his right to subscribe for its value, which will of course be \$75.00. After this transaction, he has remaining his original share of stock, which before the increase was worth \$250.00 and after the increase is worth \$175.00, and he has also the \$75.00 in cash which he received from the sale of the right, so that he is exactly where he was before the stock was increased,—no better and no worse,—but the possessor in both cases of two hundred and fifty dollars, in value of investment. It is a mere change in form of his two hundred and fifty dollars.

The issue of the right to subscribe, to be sure, splits up the certificate of stock so that he has two pieces of paper instead of one, and he may, if he likes, sell the right and thereby realize upon a part of his principal. But this would be true in exactly the same manner if another certificate for one share were issued to him by way of stock dividend, as in the Towne case, or if his original certificate for one hundred dollars par value were exchanged for two certificates of fifty dollars par value.



It is simply and obviously not true that he has received any of the corporate profits in which he has an inchoate interest as a stockholder. The corporation still retains every asset that it had before the rights were issued.

The fact that he can sell his right for something in money is a feature of absolutely no consequence whatever, and can not be regarded as anything but a change of investment if the transaction of increase of stock is clearly understood. There is not one cent more of aggregate value in the two pieces of paper than there was before in the one.

The corporation continues to hold all the assets and property which it held before the rights were issued. And the stockholder's property and assets are not in any respect increased.

Nor can the money which he received from the sale of the rights be considered in any fair sense as a gain or profit. In the illustration cited above, suppose the shareholder, besides selling his right to subscribe for \$75.00, sells immediately thereafter his original share of stock at its new value of \$175.00. He has then simply realized in the aggregate his \$250.00, and there is no gain. If, on the other hand, he holds his share for a year or two and the corporation prospers, and he thereupon sells the share for, let us say, \$200.00, the aggregate result is a gain or profit of \$25.00, because the proceeds of the right and of the share together are \$275.00.

Until, however, the share of stock, as well as the right, is sold, it is impossible to say whether a gain has resulted.

In short, in the case at bar, the defendant in error by the sale of the right on each share recouped \$358.48 of the original cost, which was \$710.00 (Record, p. 7) reducing that cost to \$351.52, so that if the original share should be sold at any price higher than the last named figure a taxable gain or profit would

result. On the other hand, if the defendant in error continues to hold the shares he may be obliged to sell them at less than \$351.52, in which event he will thus sustain a loss.

As it is clear that nothing whatever has been severed from the corporate assets, it follows that the stockholder has converted part of his own investment into the form of cash. The question of gain turns upon the cost. If he had originally bought his shares at \$100 each, the sale of the rights at \$358.48 would have been a taxable gain or profit of the excess of that sum over \$100, and when he sold the share the whole proceeds would be addition gain, and taxable.

We submit that the trial court fell into error in the case at bar in treating the sale of the rights as a transaction equivalent to, and identical with, a sale of new shares after an *exercise* of the right to subscribe. (Record, p. 8). This error, in the absence of appeal by the defendant in error, is perhaps not directly before the Court, but it is material and important in the practical interpretation of the income tax law.

In the first place, the rights were not in fact exercised and it is always a risk to predicate an argument on a non-existent fact.

Secondly, the cost of the original shares was determined when it occurred. It cannot be altered but it is subject to a credit on account whenever any integral and constituent part is disposed of as in this case. The cost of the new share, if taken up, should also be determined when it occurs. There is no difficulty in ascertaining it.

Lastly, it is not true that if the rights had been exercised each old and each new share would have cost \$430.00 as reckoned by the trial court; on the contrary each new share would have cost the cash subscription, \$150.00, plus the value of the right, \$358.48, or a total of \$508.48. This is obviously the cost

if an outsider acquires stock by buying the right and paying the subscription. Why is it not the true cost to the stockholder himself as a matter of accurate bookkeeping? If the stockholder had taken up the new share and sold it at once at that price no gain or profit would have resulted. Each old share, however, originally cost him \$710.00 and must be reckoned thereafter (whether he exercises the right to subscribe or sells it makes no difference) at a cost of \$710.00 less the value of the right, namely \$358.48, reducing the original cost, by a species of repayment on account, to the net cost of \$351.52; so that if at the same time one of the old shares were sold it would have brought \$508.48; and his total taxable gain or profit on the whole transaction would have been \$156.96, but all chargeable to the old share.

This may well be a distinction of prime importance in other cases in the light of *Doyle vs. Mitchell Bros. Co.*, *supra*, *Lynch vs. Turrish*, 247 U. S. 221, and *Goodrich vs. Edwards*, October term, 1920, for whenever the old stock was acquired prior to March 1, 1913, the gain is taxable only to the extent that it has taken place since that date.

We are aware that this argument may be inconsistent with the recent case of *Towne vs. McElligott*, 274 Fed. Rep. 960 (2nd Circuit), concerning the reckoning of cost of stock dividend shares, but we submit that the learned Court was in error in that decision, and at all events that in the case at bar the rule there laid down would not apply.

That a right of subscription is a constituent part of the share to which it pertains is generally evidenced by a fall in the market value of the share as soon as the shares sell "ex rights". Whether it is so evidenced or not, however, the sale of the right is certainly not a realizing upon the share at a profit unless and until the share itself is sold at the same time or later and the aggregate amount, so received, is more than the original cost.

It is sometimes argued in this connection that the drop in market value of the shares, which accompanies the issue of rights, is of no significance on the question of income and principal because a similar effect follows a cash dividend, especially a large one, and a cash dividend is certainly income, and taxable.

The latter is true, but the conclusion drawn from the argument shows a regrettable carelessness of thought. It fails to note that the cause of the fall in value in one case is radically different from that in the other. A cash dividend is a *distribution*, and actually reduces the assets in the treasury of the corporation; an issue of rights to subscribe and an increase of stock, on the other hand, is not a distribution, and does not reduce the assets; it does, however, *dilute* those assets by the fact that they are represented by a larger number of shares and hence the value of each share is less than before. The cash dividend has left the corporation and become the property of the stockholder, while in the case of an issue of rights nothing has left the corporation and the stockholder has no new property but has two pieces of paper to represent exactly the same property he had before.

That there has been no distribution appears obvious. It is certainly clear enough to the stockholder who takes up his rights instead of selling them. From the standpoint of the corporation it is equally so. And the stockholder who sells his rights and uses the proceeds as income, has frequently cause to regret his folly, and to perceive that, in spending the money, he has been living on his principal.

### THE LIFE TENANT CASES

Upon the point at issue in the case at bar there is no direct authority except the discredited Trefry case in Massachusetts, but in the life tenant cases the character and inherent nature of

rights to subscribe have frequently been examined and discussed. The question of definition has been vital; and of all the precedents in the books those cases should unquestionably be the most persuasive.

Recent decisions of this Court however have made it unnecessary to argue at length the strong analogy and logical connection between the life tenant cases and case involving the income tax. In *Towne vs. Eisner*, 245 U. S., 418, this Court said:

"We cannot doubt that the (stock) dividend was capital as well for the purpose of the income tax law as for distribution between the tenant for life and remainderman. What was said by this court (in *Gibbons vs. Mahon*) on the latter question is equally true for the former."

In *Eisner vs. Macomber*, 252 U. S., 189, the *Towne* case is re-examined and the principle underlying its decision affirmed, the statement being:

"The conclusion there reached as to the essential nature of a stock dividend necessarily prevents its being regarded as income in any true sense".

and again,

"The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit."

We submit that the law applicable to the case at bar gathered from the above and other recent decisions of this Court is, that whenever corporate action, as distinguished from dealings by the stockholder with his stock, is the basis for the stockholder's receiving either cash dividend, stock dividend, a dividend in specie, a right to subscribe for additional stock, or a dividend in liquidation, the primary and fundamental criterion upon the question of income taxation is whether or not anything has passed out of the corporation treasury into that of the stockholder.

Either money or property may so pass, and will in some cases be income and in others capital; but if *nothing* passes out of the corporate treasury then no income can possibly result to the stockholder from the action taken by the corporation. Eisner vs. Macomber, *supra*, p. 209.

If an issue of rights is in itself income it must be taxable as such whether exercised or sold. But it is absurd to say that an option to *contribute* more capital is identical with *receiving* something *from* the corporation.

So far as this conclusion is based upon the authority and reasoning of the life tenant cases, we believe it is clear that those cases firmly establish the status of proceeds of sales of rights to subscribe as capital.

In that line of decisions there is some diversity with reference to stock dividends, some courts awarding them in whole or in part to the life tenant. In States holding stock dividends to be capital, it is naturally held also that proceeds of sale of rights are capital. Boardman vs. Mansfield, *supra*, and cases therein cited, because the fundamental fact is the same in both cases, viz: that nothing passes out of the corporate treasury to the stockholders.

In order, therefore, to establish our proposition we have only to deal with those States holding heterodox theories concerning stock dividends. In those States a stock dividend being described as a "distribution" we might well expect to find a like error to prevail in regard to rights to subscribe. Such, however, is not the law. Even in those States it is universally held, with one single exception so far as laborious search can discover, that such rights, whether exercised or sold, belong to the corpus of the trust fund. That exception is the case of Holbrook vs. Holbrook, 74 N. H., 201, in comparison with which, and impairing its force, see Walker vs. Walker, 68 N. H., 407, and other New Hampshire decisions.

It has sometimes been said that in Pennsylvania, which is the stronghold of the theory that stock dividends are in some cases income for the life tenant, the case of *Wiltbanks' Appeal*, 64 Pa. St. 256, establishes the law of that State to the effect that proceeds of rights are also income. We submit that such is not the law of Pennsylvania, and call attention to three subsequent decisions holding that such proceeds belong to the capital. This indicates that *Wiltbanks' Appeal* must be considered to stand on its own peculiar facts.

The three cases mentioned are, first, *Moss's Appeal*, 83 Pa. St. 263, in which the decision of the Court is based on the consideration that there is no distribution and no profit to the stockholder; second, *Biddle's Appeal*, 99 Pa. St. 278, where the Court says:

"The right of a stockholder to subscribe for new stock was a right to change the form of the investment, but that which existed as principal did not, by the exercise or sale of that right, become income. The appellant became entitled to the income on that principal in its changed form, but not to the principal itself."

and third, *Eisner's Estate*, 175 Pa. St. 143, where the Court said that a privilege of subscription, even if sold at a premium, is

"far from proving that the premium is to be regarded as income, the payment or withdrawal of which leaves the original capital unimpaired."

and again,

"When new stock is issued at par the actual increase of capital is precisely the amount thus received by the Company and if the new stock has at the time an intrinsic value beyond what was paid for it, this presumptively can only be because the holders of the new stock have been put on a footing of equality with holders of old stock and thus become entitled to share with them in a distribution of assets should the corporation be

dissolved. The gain of the new stockholders is the precise measure of loss of the old stockholders. This is very clear."

In Kentucky, which is another State expressly describing stock dividends as a "distribution" which goes to the life tenant, it is nevertheless held that rights to subscribe are principal, the Court saying, in *Hite vs. Hite*, 93 Ky. 257,

"It is a mere incident to the old stock, a right appurtenant to it, and, as such, part of the capital. It cannot fairly be considered as income."

In New York, where it is difficult to say what are the rights of a life tenant in a stock dividend, the Court of Appeals has squarely held that proceeds of sale of rights are capital and belong to the remainderman. In *re Kernochan*, 104 N. Y. 618. The Court describes them as only the right "to change the manner of the investment" (of the principal). See also, *accord*, *Robertson vs. Brulatour*, 188 N. Y., 301, and the clear discussion in *Richmond vs. Richmond*, 123 N. Y. App. Div. 117.

In 2 Cook on Corporations, Sec. 559, a work which is quite sympathetic to the view that stock dividends ought to be apportioned, the learned author nevertheless lays down the principle as unquestioned that rights to subscribe, whether exercised or sold, belong to the remaindermen. He describes such rights as "an incident of the ownership of the stock."

The exhaustive and luminous analysis of the relationship of stockholders to the corporation upon the declaration of a stock dividend contained in *Eisner vs. Macomber* makes it unnecessary to call attention to any other discussion of that subject. The continuation of this exposition, however, and the application of the same fundamental principles to the proceeds of



sales of rights and to other corporate transactions closely connected with this subject can be found in a set of Connecticut decisions of unusual force and lucidity of statement.

- Smith vs. Dana, 77 Conn. 542, (an extraordinary cash dividend).  
 Bulkley vs. Worthington Ecclesiastical Society, 78 Conn., 526, (cash received in liquidation).  
 Boardman vs. Mansfield, 79 Conn., 634, (Sale of rights to subscribe).  
 Bishop vs. Bishop, 81 Conn., 529, (Adams Express bonds issued to stockholders 1907).

In Boardman vs. Mansfield the Connecticut Court said (after discussing the effect of stock dividends).

"That principle is, that until there has been some action by a corporation setting apart from the body of its assets some portion of them to become the property of its stockholders, and thus to pass out of the dominion of the corporation into that of the stockholders, there is nothing in existence to which the right of the latter can attach otherwise than as it attaches to the corporate interest as a whole—nothing which can as to them be regarded as partaking of the nature of profits from the corporate investment." (citing cases).

The Court then takes up the sales of rights to subscribe:

"Applying this principle to situations where new stock is issued and the right to subscribe therefor is accorded to shareowners pro rata..... we find that it is always true that no asset of the corporation is set apart to become the shareowner's. The corporation parts with nothing. The shareowner gets nothing which was before a part of the corporate property..... If he exercises his right to subscribe for his pro rata share, and pursuant to the terms of that right pays in to the corporation the full par value of his subscription, or some lesser sum supplementing a part payment from surplus assets thus capitalized, the result is again the ownership of more shares than before, but his total ownership represented by them forms a no greater proportion of the corporate assets than he formerly held.

and those assets are precisely what they were, save as they have been increased by the subscription payments to which he has made his proportionate contribution. . . . . So if, instead of exercising his right to subscribe, the stockholder sells it for its true value and his assignee steps into his place, the seller will, indeed, when the transaction has been closed, find himself with a sum of money in his pocket which he can call his own, but the certificate of stock which has remained in his strong box, while bearing the same figures as formerly, will represent as much less of true value as is measured by the money received. . . . . Whenever, therefore, as the result of a stock issue, of whatever form, nothing is by the corporation separated from the corporate assets to pass out, or which at the option of the shareowner may pass out, from the dominion of the corporation into that of the shareowners, no condition is created which permits of a life tenant receiving anything in hand which is not inevitably subtracted from that which, in the possession of the trustee, represents ownership in the corporation, and nothing else,—from that, therefore, which under our law is the corpus of the trust estate. What the life tenant thus received would come from somewhere. It would not come from the corporation. It could only come from, or at the expense of, the fund held by the trustee before the transaction had its inception, and result in the fund's depletion as its consequence. The executors of the life tenant can not, therefore, have either the proceeds of sale of, or profits derived from the utilization of, the rights under consideration."

"The inequity of any other conclusion has led courts holding other views than ours upon the general subject of the rights of life tenants (i. e. upon stock dividends) to agree that the ownership of rights such as are under consideration attaches to the corpus of trust funds. *Moss' Appeal*, 83 Pa. St. 264, 270; *Biddle's Appeal*, 99 id. 278; *Eisner's Estate*, 175 id. 142, 34 Atl. 577; *Walker vs. Walker*, 68 N. H. 407, 39 Atl. 432; *In re Kernochan*, 104 N. Y. 618, 11 N. E. 149; *Hite vs. Hite*, 93 Ky. 258.

See to the same effect:

*DeKoven vs. Alsop*, 205 Ill. 309, 68 N. E. 930;  
*Bouch vs. Sproule*, L. R. 12 App. 385; *In re Barton's Trusts*, 17 Law Times Rep. N. S. 594."

In 2 Perry on Trusts (Sixth Edition, Sec. 545) the writer says:

"Rights given to stockholders to subscribe at par for new shares of stock in a corporation whose stock is worth more than par do not belong to income even in jurisdictions which give to income stock dividends which are based upon earnings". (Citing many cases).

"This disposition of rights is not inconsistent with the Pennsylvania rule that stock dividends based upon earnings should be given to those entitled to income during the time when the earnings were accumulated, for they are not dividends in any sense. Although the value of the rights may be due to the existence of a fund of undivided earnings, and although the issue of new stock increases the number of shares which may at some time become entitled in a division of these earnings, there is no division of these earnings and no change in the manner in which the corporation holds them. There is no certainty that the earnings will ever be divided and usually no way of determining accurately how much of the value of the rights is due to their existence and how much to other causes. *Moss's Appeal*, 83 Pa. St. 264."

In Loring's book called "A Trustee's Handbook", 134, the writer says:

"The right to subscribe for new stock, whether availed of or sold for cash, is generally held in all jurisdictions, irrespective of rules governing extra dividends, to be principal. The granting of such a right is really not a 'dividend,' properly speaking, at all, though often called so in discussing these questions."

In Howes' "American Law Relating to Income and Principal," 46, the same rule is stated and the writer says:

"Rights, although valuable, are not dividends, and the gain from a sale of rights will usually be exactly balanced by a loss in value of the old shares. (Citing many cases)."

"This rule is not inconsistent with the doctrine that stock dividends founded upon earnings belong to income, because, although the rights may be valuable on

account of an accumulation of surplus earnings, the issue of the new stock for which the par value is paid does not represent a division of these earnings. The issue of new stock simply increases the number of shares that are entitled at some time to a division of the earnings."

See to the same effect 1 Machen on Corporations where the writer adds, (See, 607),

"The cases are, to say the least, rare in which life tenants even in states which adopt the rule of apportioning stock dividends have been awarded any part of the value of the pre-emptive right."

We submit that the foregoing review of the life tenant decisions places substantially the entire body of authorities from that source in support of the defendant in error, and establishes the contention that the rights and the proceeds of their sale are a constituent part of the stock itself and not a new and separate right, privilege or benefit, produced or created by the corporate action increasing the stock, or existing as the fruit or profit of the capital investment.

Whether the stockholder made his investment at par when the corporation began its existence, or bought his shares later at the maximum price representing its accumulated profits and prosperity, can make no difference because in either case nothing has departed from or been taken out of the corporation treasury. Whether the taxpayer may be subject to income taxation for some part of the proceeds of sales of these rights considered as gains or profits upon his original investment, and when, is an entirely different question, and is discussed elsewhere in this brief.

## TREFRY vs. PUTNAM, 227 Mass. 522

In *Eisner vs. Macomber*, *supra*, this Massachusetts case, much relied upon by the Government, was rejected by this Court in the following sweeping and emphatic terms (p. 217):

"Evidently . . . . . it was deemed necessary to take the symbol for the substance, accumulation for distribution, capital accretion, for its opposite; while a case where money is paid into the hand of the stockholder with an option to buy new shares with it, followed by acceptance of the option, was regarded as identical in substance with a case where the stockholder receives no money and has no option".

It would appear that little more need be said about this case in a court of the United States.

It is, however, the only direct authority bearing upon the case at bar and a few words may be useful.

If the Putnam case was grievously erroneous as to stock dividends, it must be equally so with regard to the sale of rights to subscribe. The Massachusetts court itself said in that case that the two stand on the same footing and must both be disposed of in the same manner. The ruling as to rights was accordingly the same as the rejected ruling as to stock dividends.

It should be noted that upon these two points the decision was by a divided court.

It should also be noted that the Massachusetts Court was interpreting a Constitutional Amendment which was passed to create new powers of taxation and new subjects of taxation while with the Sixteenth Amendment of the United States Constitution, there was no such necessity, purpose or result.

The failure of the Massachusetts Court to reach results in accordance with the conclusions of this court is rather significantly indicated by its allusion to the *Turrish* and *Lowe* cases.

in the Putnam case the Court said, "So far as there may be anything at variance with this conclusion (as to dividends) in *Lynch vs. Turrish*, 149 C. C. A. 649, we are constrained not to follow it. See in this connection *Southern Pacific Co. vs. Lowe*, 238 Fed. Rep. 847." Unfortunately for the Massachusetts court, the Turrish decision thus discarded has been affirmed by this court, while the Lowe case, which was favorably regarded, has been reversed.

The opinion in the Putnam case is hardly fair in stating the law of other States in the life tenant cases on the subject of rights to subscribe. It cites the case of *Whitbanks' Appeal*, 64 Pa. St. 256, above discussed, as representing the law of Pennsylvania, and holds language on the subject carrying the implication that there is a body of law on both sides of the point, similar to the differences of opinion concerning stock dividends, whereas it should not have been disregarded by that Court that notwithstanding such differences of opinion, practically all jurisdictions agree, including Pennsylvania, that sales of rights to subscribe are not income for the life tenant.

Again, the Massachusetts statute said, "No distribution of capital . . . . shall be taxable as income . . . . but accumulated profits shall not be regarded as capital". The Court said "accumulated profits are used as the antithesis of 'distribution of capital'". This is clearly an erroneous interpretation. There is no such antithesis. The distinction in the statute is only that *if* there is a *distribution* of accumulated profits, it shall be taxable. Neither a stock dividend nor an issue of rights is a distribution of anything.

Again, when the Massachusetts Court said, with reference to rights, "They are not regarded ordinarily as a profit from the prosecution of business but are an inherent and constituent part of the shares", it is very difficult to comprehend how the rights

could have been treated, even when sold, as income. Taxation on that basis might be comprehensible if the stockholder had sold not only the rights but the shares themselves, and if furthermore the aggregate amount derived from the sale of the shares and the rights showed a gain over the cost, but the sale of "a constituent part of the shares" is merely a conversion into money of a *part* of the stock itself.

It would seem impossible that the case could be rejected by this court as a precedent in regard to stock dividends and be accepted as having weight in the case at bar. The Massachusetts Court itself recognizes that the Amendment of its Constitution and the decision of the case rest upon different grounds than would be applicable to the Federal income tax statutes. It said, page 530, alluding to the Federal cases of *Gray vs. Darlington*, *Lynch vs. Turrish* and *Lynch vs. Hornby*:

"But the grounds upon which this judgment rests are such as to render unnecessary a critical examination of those decisions. They relate to other statutes enacted under constitutional provisions different from those of the Forty-fourth Amendment."

## CONCLUSION

We submit that the underlying principles determining the essential nature of receipts as capital or income are the same as regards stock dividends and rights to subscribe; that *Eisner vs. Macomber* is decisive of the case at bar; that the logical connection of the life tenant decisions is obvious and their unanimity overwhelming in support of the defendant in error; that the Massachusetts decision cannot be regarded as an asset to the Government; that Congress in the income tax laws, although specifying various classes of receipts as income, has never, either in 1867 or in the recent Acts, attempted to include

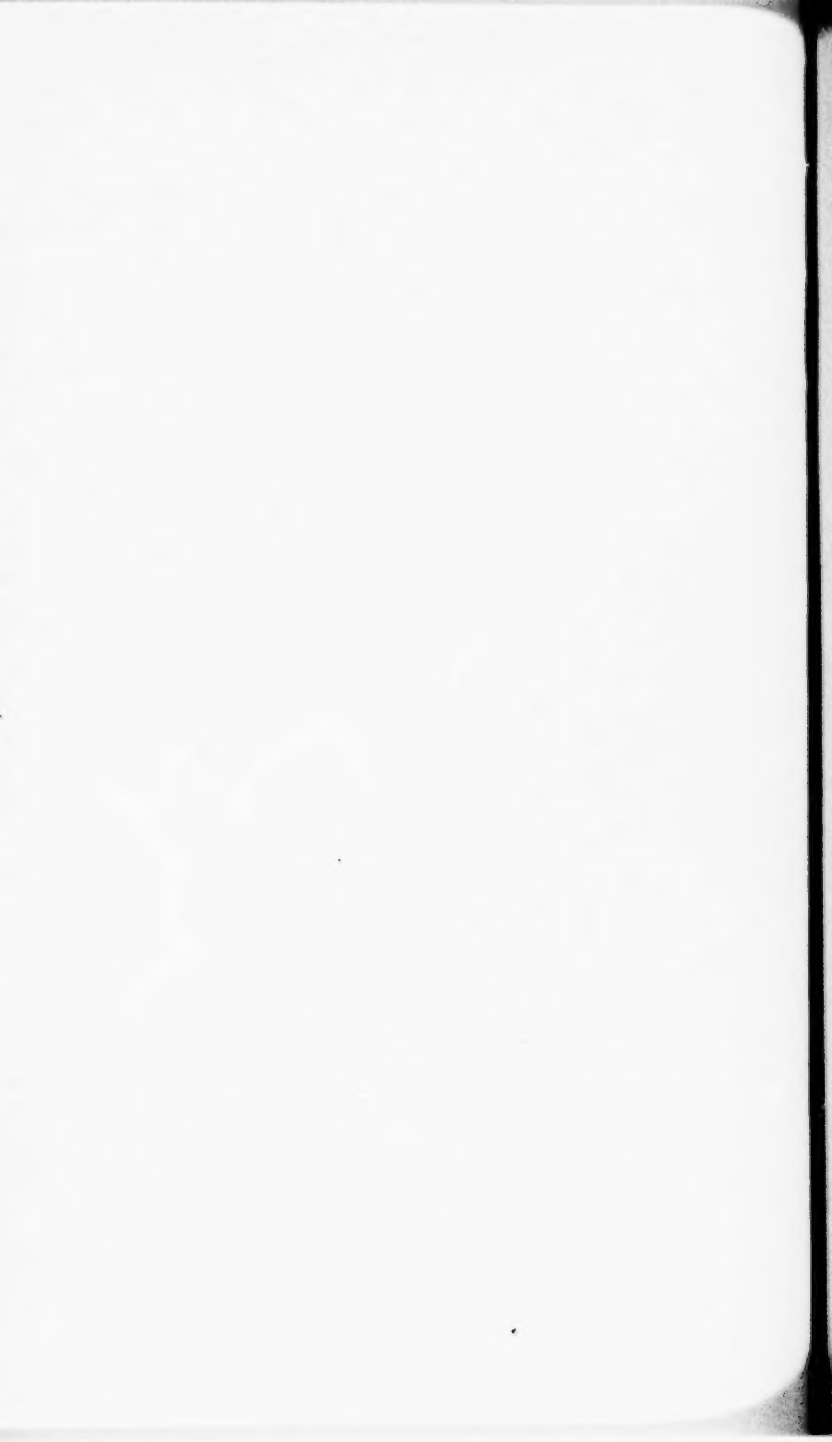
proceeds of rights to subscribe in terms, nor generally unless they can be brought under the term "distribution", which would be contrary to the fact; and lastly, that as the rights are a constituent part of the shares themselves and are capital, no taxation can be predicated upon their sale as a realized gain or profit on the sale of capital assets unless and until the entire property, that is the share itself as well as the right, is sold and the aggregate result in money received exceeds the original cost of the share. If, however, we are in error upon the last point, then we submit that the judgment of the trial court should be sustained upon the principles therein stated.

Respectfully submitted,

ARTHUR M. MARSH.

*Amicus Curiae.*





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# Supreme Court of the United States.

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October Term, 1921.No. 416.

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JOSHUA W. MILES, Collector of Internal Revenue for the  
District of Maryland,

*Plaintiff-in-error,*

*vs.*

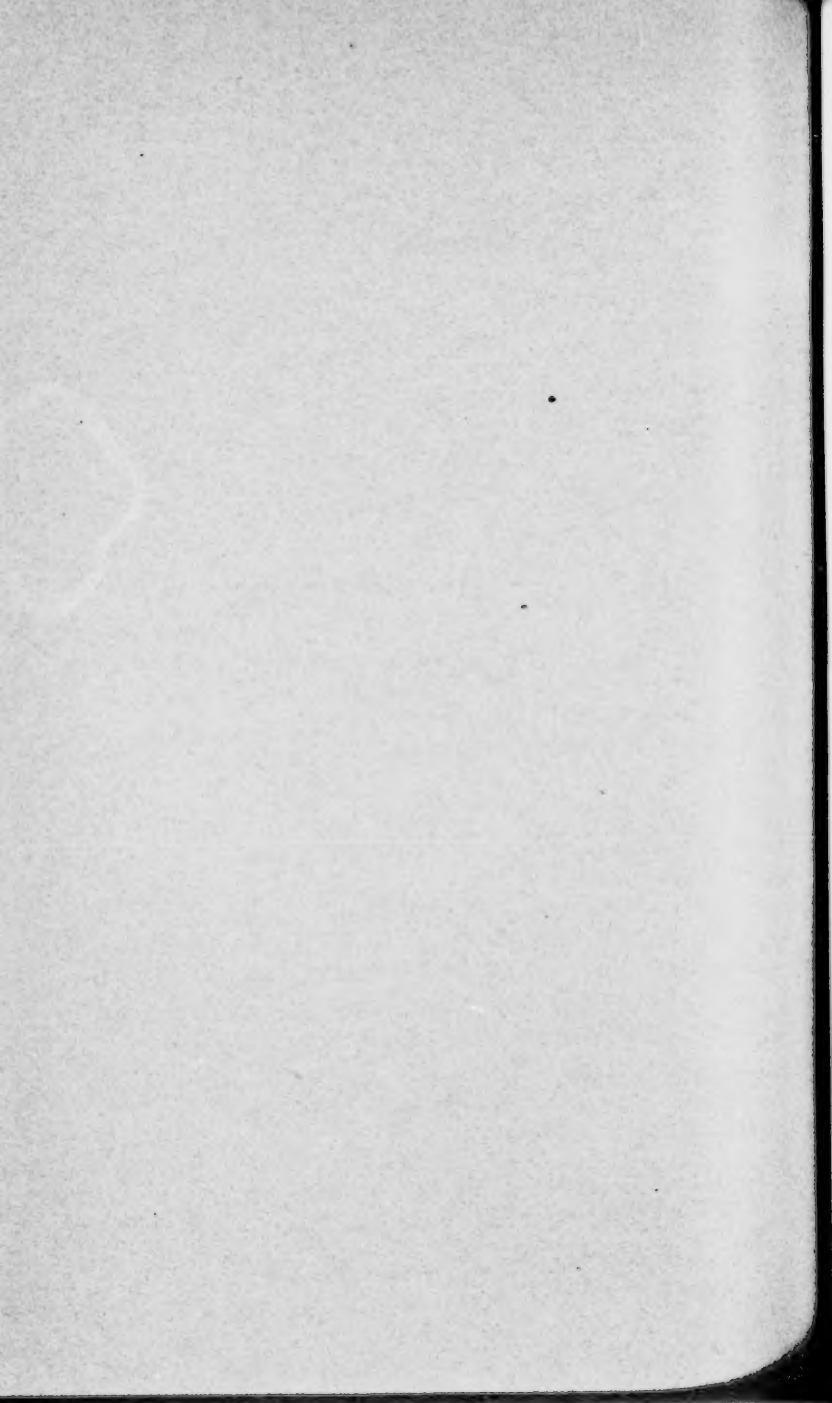
THE SAFE DEPOSIT & TRUST COMPANY OF  
BALTIMORE, Guardian of Frank R. Brown,

*Defendant-in-error.*

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BRIEF OF MANSFIELD FERRY FILED AS AMICUS  
CURIAE, AND ON BEHALF OF THE FARMERS  
LOAN & TRUST COMPANY, Trustee, UNDER  
TRUSTS CREATED BY ARCHIBALD D. RUSSELL,  
deceased.

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# Supreme Court of the United States,

OCTOBER TERM, 1921.

No. 416.

JOSHUA W. MILES, Collector of Internal Revenue for the District of Maryland,  
Plaintiff-in-Error,

*vs.*

THE SAFE DEPOSIT & TRUST COMPANY OF BALTIMORE, Guardian of FRANK R. BROWN,  
Defendant-in-Error.

## **BRIEF OF MANSFIELD FERRY FILED AS AMICUS CURIAE AND ON BEHALF OF THE FARMERS' LOAN AND TRUST COMPANY, TRUSTEE, UNDER TRUSTS CREATED BY ARCHIBALD D. RUSSELL, DECEASED.**

This brief, by permission of the Court, and with the consent of counsel appearing in the cause is filed by the undersigned as *amicus curiae*, and on behalf of The Farmers' Loan and Trust Company, Trustee under certain trusts created by Archibald D. Russell, deceased.



The question raised here by the appeal of the Government from the decision of the lower court is the taxability as income (by virtue of the Sixteenth Amendment and the several revenue acts enacted thereunder and particularly the Revenue Act of 1918) of the *entire* proceeds from the sale of rights to subscribe to a new issue of the capital stock of a corporation.

The case was brought in the lower court by the defendant here, who sued to recover back the amount of taxes collected by the plaintiff-in-error upon the proceeds received by the defendant-in-error on a sale of rights to subscribe to new shares of stock on an increase of capitalization of a corporation in which it was a stockholder, upon all of which proceeds the plaintiff here had assessed a tax as income. The government, the plaintiff-in-error, supports this tax, contending that the entire amount of proceeds of such sale is income, and that the original cost of such shares to the taxpayer is not material. The trial court held the proceeds, while not taxable *in toto*, nevertheless taxable in part. The defendant-in-error has not appealed from the calculation of the lower court.

The narrow issue presented to this court should be emphasized. The only error assigned is that alleged by the plaintiff-in-error

“That the said district court erred in refusing the prayer offered by the defendant, which prayer is as follows, viz.:

“The defendant prays the court to instruct itself sitting as a jury that the plaintiff has offered no evidence in this case legally sufficient to entitle it to recover, and therefore the verdict of the court sitting as a jury shall be for the defendant’ ” (Record, p. 21).

In view of the fact that the plaintiff below has acquiesced in the decision of the District Court, the sole question presented to this court is whether the *entire* proceeds of the sale are or are not income and taxable as such. If not, the decision of the lower court, and its calculation of the portion of the proceeds taxable as income, must manifestly be affirmed.

The Farmers' Loan and Trust Company, as trustee under five trusts created by Archibald D. Russell, deceased, was a shareholder of the National City Bank of New York.

The Farmers' Loan and Trust Company as such trustee in 1920 received \$461,550 as the proceeds of the sale of rights to subscribe to new stock to be issued by the Bank to old shareholders at less than the prevailing market price for its stock; this sum is but a small part of the original cost of acquisition of those shares. The facts of these transactions have been reported by the Trustee in its income tax reports for the year 1920, and if the contention of the Government be sustained, income taxes aggregating more than \$125,000.00 will be imposed upon this reimbursement of a part of the original investment.

### **Points of Argument.**

1. Only income may constitutionally be taxed without apportionment.
2. The right to subscribe to a new issue of stock is an inherent power of the shareholder as an attribute of his right to maintain his proportionate interest in the corporation.

3. The rights to subscribe to new stock and the proceeds of sale thereof are principal and not income.

(a) They are principal as between life tenant and remainderman; and

(b) They are likewise principal and not income under the Income Tax Laws.

4. The taxability of the proceeds of the sale of rights is controlled by the decisions of the Supreme Court in the stock dividend cases of *Towne v. Eisner*, 245 U. S. 418; and *Eisner v. Macomber*, 252 U. S. 189; See also *Towne v. McElligott*, 274 Fed. 960.

5. Hence the entire proceeds of the sale of stock rights, not being income in fact, are not income under the Sixteenth Amendment and are therefore not taxable under any Federal Income Tax Law.

6. The case of *Trefry v. Putnam*, 227 Mass. 522, has already been discredited by this Court in the case of *Eisner v. Macomber*, *supra*.

## POINT I.

### Only income may constitutionally be taxed.

“The Sixteenth Amendment was adopted in words lucidly expressing the object to be accomplished,” *Eisner v. Macomber*, 252 U. S. 189, 216. 205

That object is that,

“The Congress shall have power to lay and collect taxes on incomes, from whatever

source derived, without apportionment among the several states, and without regard to any census or enumeration." (Italics ours.)

This amendment, as said in *Eisner v. Macomber*, *supra*, p. 206

"shall not be extended by loose construction, so as to repeal or modify, except as applied to *income*, those provisions of the constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the Courts." (Italics ours.)

No new power of taxation was conferred on Congress by this amendment. It "merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income." *Eisner v. Macomber*, *supra*, citing *Brushaber v. Union Pacific R. R.*, 240 U. S. 1, 17-19; *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 112 *et seq.*; *Peck & Co. v. Lowe*, 247 U. S. 165, 172, 173. But all the cases are squarely predicated on the assumption that the thing taxed is income, and income is defined as "a gain derived from capital, from labor, or from both combined," as stated in *Stratton's Independence v. Howbert*, 231 U. S. 399, 415, "provided it be understood to include profit gained through sale or conversion of capital assets," as added to and adopted by *Eisner v. Macomber*, *supra*.

The word "income" must be given the same meaning in all of the Income Tax Acts of Congress that was given to it in the Federal Corporation Excise Tax Act. *Merchants Loan & Trust Co. v. Smietanka*, 255 U. S. 509, 41 Supt. Ct. 386, decided March 28th, 1921.

The decisions are clear that it is only income that can be taxed, as income is defined in *Stratton's Independence v. Howbert, supra*, and *Eisner v. Macomber, supra*.

Sec. 213 (a) of the Revenue Act approved February 24th, 1919, defines gross income, as including

"gains, profits and income derived from \* \* \* sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property \* \* \*."

To bring the transaction of the Safe Deposit & Trust Co., guardian, in disposing of the rights to subscribe to stock, within the limitation of the act, and of *Eisner v. Macomber*, it is essential that there must have accrued to the Safe Deposit & Trust Co., guardian, a gain, profit <sup>or</sup> ~~and~~ income. The Courts having a knowledge of the intricacies of business, and of commercial transactions, will look to the substance, and not the mere form, in determining whether in fact there has been a gain, profit and income. *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179; *Eisner v. Macomber, supra*. If there be in fact no gain, profit or income, there is nothing to tax under the Sixteenth Amendment. There must be a gain realized from the transaction. *Goodrich v. Edwards*, 255 U. S. 527, decided March 28, 1921:

"It is thus very plain that the statute imposes the income tax on the proceeds of the sale of personal property to the extent only that gains are derived therefrom by the vendor \* \* \*"  
*Goodrich v. Edwards, supra*, p. 535.

On the sale or other disposition of property, it is only the excess over the *original* cost, realized

in money or money's worth, that is income, and even this is subject to the limitation laid down in *Merchants Loan & Trust Company v. Smietanka*, 255 U. S. 509, 41 Supt. Ct. 386, decided March 28, 1921.

It is thus clear that to render the taxpayer chargeable with a tax there must be a gain, profit or income to the taxpayer, and that the substance of the transaction is the criterion, and not the mere form. *Doyle v. Mitchell Bros. Co.*, *supra*, and *Eisner v. Macomber*, *supra*.

## POINT II.

### **The right to subscribe to a new issue of stock is inherent in the ownership of stock.**

The right of a shareholder in a corporation to participate in the issue of new stock, whether issued from the assets of the corporation itself, as a purely stock dividend, or for money or moneys equivalent, or part in a book transfer of assets and part in money or moneys equivalent, in proportion to his holdings in the corporation is an inherent right of his ownership or shareholding. *Stokes v. Continental Trust Company*, 186 N. Y. 285, 295, 297, 78 N. E. 1090. This right cannot be abridged or aborted in any way by the corporation.

*Stokes v. Continental Trust Co.*, *supra*.

*Witherbee v. Bowles*, 201 N. Y. 427-431.

*Hoyt v. Great American Ins. Co.*, 188 N. Y. S. 257 (March Term 1921).

*Snellings et al. v. Richard et al.*, 166 Fed. 635.

*Bates v. United Shoe Machinery Co.*, 206 Fed. 725.

The right can, of course, be waived, or lost by laches or acquiescence by the stockholder. *Hoyt v. American Ins. Co.*, *supra*. But in the case at bar the right was exercised by a sale of it.

### POINT III.

**Rights to subscribe to new stock and the entire proceeds of their sale are not income, either as between life tenant and remainderman or for federal income tax purposes.**

(a) *Courts have always considered them corpus, as between life tenant and remainderman.*

Except for one case in New Hampshire (*Holbrook v. Holbrook*, 74 N. H. 201), the courts with practical unanimity have held that as between the life beneficiary and the remainderman of a trust fund in stock, the value of an option to subscribe for new stock, or stock received thereunder, or the proceeds of the sale of such option, or new stock purchased with such proceeds, or any increase of the market value of the stock is not income, but a part of the principal, and goes to the remainderman.

See

14 Corp. Jur. 399.

*In re Kernochan*, 104 N. Y. 618, 11 N. E. 149.

*Robertson v. De Brulatour*, 188 N. Y. 301.

*Boardman v. Mansfield*, 79 Conn. 634.

*Spooner v. Phillips*, 62 Conn. 62.

*Eisner's Estate*, 175 Pa. St. 143, 34 Atl. 577.

Biddle's Appeal, 99 Pa. St. 278.

Hite *v.* Hite, 93 Ky. 257.

DeKoven *v.* Alsop, 205 Ill. 309; 68 N. E. 930.

Lauman *v.* Foster, 157 Iowa 275.

Hyde *v.* Holmes, 198 Mass. 287.

Walker *v.* Walker, 68 N. H. 407, 39 Atl. 432.

The last case is in conflict with *Holbrook v. Holbrook*, *supra*.

Though there is a division of opinion as to stock dividends being considered a part of the corpus, and not income, as between life tenant and remainderman, (this Court taking the position that they belong to the principal—*Gibbons v. Mahon*, 136 U. S. 549), there seems to be no real doubt (except the conflict in New Hampshire between the cases there) that the proceeds of the sale of rights belong to the corpus of the estate or trust, and are not income (cases, *supra*). The Kentucky Supreme Court has adopted this principle in *Hite v. Hite*, *supra*, notwithstanding that in the same decision it held stock dividends to be income, and to go to the life tenant.

A leading and very well reasoned case is *Boardman v. Mansfield*, *supra*. The Court in that case said at p. 639 that the

“principle is, that until there has been some action by a corporation setting apart from the body of its assets some portion of them to become the property of its stockholders, and thus to pass out of the dominion of the corporation into that of the stockholders, there is nothing in existence to which the right of the latter can attach otherwise than as it attaches to the corporate interests as a



whole—nothing which can as to them be regarded as partaking of the nature of profits from the corporate investment.”

This principle, insofar as it relates to stock dividends, has been fully settled for Federal Income Tax purposes, in *Towne v. Eisner* and *Eisner v. Macomber, supra*.

The Connecticut court, in the same case, further stated as to the sale of the rights, on page 641:

“So, if instead of exercising his right to subscribe, the stockholder sells it for its true value and his assignee steps into his place, the seller will, indeed, when the transaction has been closed, find himself with a sum of money in his pocket which he can call his own, but the certificate of stock which has remained in his strong box, while bearing the same figures as formerly, will represent as much less of true value as is measured by the money received.”

The Court of Appeals in New York, <sup>in</sup> *In re Kernochan, supra*, held that the proceeds of the sale of rights to subscribe were capital belonging to the corpus and not to the life tenant, and said that they are only the right to change the manner of its investment.

The cases voicing this doctrine are numerous, but the principle enunciated in each is merely the principle set out in *Towne v. Eisner* and *Eisner v. Macomber, supra*, concerning stock dividends and concerning the Federal income tax, applied with even greater force and directness to rights to subscribe to stock and their proceeds.

*(b) Rights to subscribe to new stock, and the entire proceeds of their sale, are not income taxable under the Federal Income Tax Laws or the Constitution.*

It is vital to distinguish between the two steps involved in the sale of rights to subscribe to new stock. The first step is the resolution of the directors or stockholders to offer new stock for subscription by the old stockholders (Record, p. 13). This vests each old stockholder with a right to acquire an additional share or shares of stock upon the terms named in the resolution which in the case at bar happened to be the payment of \$150. for each new share of stock to which he has a right to subscribe. But be it noted that the corporation has done nothing but to make definite the inchoate right inherent in every stockholder of preserving his proportionate interest in the corporation.

The second step that was taken by the defendant in error in this case was to sell these "rights" which became vested in him.

In discussing the issue presented in this case, i. e., whether the entire proceeds of the sale of these rights are taxable income under Federal Laws, it will be helpful to consider first the nature of these "rights" as between the corporation and the stockholder; and second, the nature of the thing which the stockholder has disposed of when he sells his "rights."

In offering new stock for subscription, the corporation says in effect to its shareholders:

"Our capital is insufficient for our present needs. Because of your rights as a shareholder, we are forced to give you the opportunity of sup-

plying any additional capital that the corporation may raise by the issue of stock, and, if you chose to do so, you may buy one new share of stock for each share of stock that you now hold and thereby maintain your proportionate interest in the corporation. In spite of our large surplus, your directors have not deemed it wise to issue a stock dividend to you, for that will not bring in one dollar of additional capital and therefore will not relieve the necessities of the corporate treasury. But, nevertheless, since as a shareholder you are entitled ultimately to all the assets of the corporation after the prior claims have been paid, we will not ask you to pay for this new share of stock the actual value of the portion of the surplus to which it will be entitled upon its issue. You will be paying more than the par value of the stock, but there will accrue to the new stock an indivisible part of the surplus that now belongs to the old shares which you now own and which, if you do not subscribe, will be lost."

The corporation distributes nothing to the stockholder. On the contrary, any distribution would seem to be by the stockholder to the needs of the corporate treasury. Nothing has been severed; the stockholder, when he subscribes to his rights, has merely his original interest in the enterprise, the value of which has been enhanced by the amount of the subscriptions for new stock which he and other stockholders have contributed to the assets of the corporation. In the words of this Court, in speaking of stock dividends in *Eisner v. Macomber*, *supra*, there is nothing

"of exchangeable value *proceeding from* the property *severed from* the capital however

invested or employed, and *coming in*, being '*derived*,' that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* benefit and disposal;—*that* is income derived from property. Nothing else answers the description." \* \* \* p. 207

"On the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from ~~the~~ employment of his money and that of the other stockholders in the business of the Company, still remains the property of the Company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment" p. 211

If the stockholder wishes to avoid furnishing new capital stock to the corporation, he can dispose of his "rights" for a price, but even when this is done he has a diminished interest in the corporation and a diminished asset value. In effect he has by the sale of his rights partly liquidated his interest in the corporation. It is manifest that his interest in the corporation was capital and therefore that his sale of rights is a sale of capital assets of which only the gain and not the gross amount is taxable as income.

*Goodrich v. Edwards, supra.*

As a shareholder has a proportionate interest in all the assets of the corporation an increase in the stock by transferring from surplus account, or profit and loss account, to capital stock account of sufficient assets to represent the value of the new issue neither enriches nor impoverishes the

stockholder in any degree. His proportional rights and interests are the same. He has realized no profit or gain. The only change is in the evidence which represents the interest or right. Mere paper evidence of ownership is not gain.

*Eisner v. Macomber, supra.*

An issue of new stock may or may not affect the actual value of the old stock. This is a matter of fact. An issue of new stock, one new for each old share, from the surplus assets of the corporation would cut in half the actual value of the old stock. An issuance of new stock for a money consideration equal to the actual value of the old would leave the actual value of the old unaffected and unimpaired. An issuance of new stock for a money consideration less than the actual value of the old would depreciate the value of the old shares proportionately. Under any of these circumstances there is no gain, profit nor income to the shareholder until he has disposed of his stock; but on such a sale of his dividend stock

“he necessarily disposes of a part of his capital interest just as if he should sell a part of his old stock either before or after <sup>the</sup> dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the Company likewise is diminished.”

*Eisner v. Macomber, supra.* p. 212.

To tax the whole proceeds of sale of the rights to subscribe, as provided by Art. 39 of Regulations 45, of the Treasury Department, and as contended for by the government, would be to ignore the principle enunciated as to stock dividends in

Eisner *v.* Macomber, *supra*, and to ignore the obvious fact that the actual value of the old shares has been proportionately depreciated, and would be to levy a direct tax on capital, and not on income.

The issue of rights to subscribe to new stock is even less income than the issue of stock as a dividend. In the case of a stock dividend, nothing is required of a shareholder in order that he may retain his *status quo* and his proportionate interest and representation in the corporation. In the case of stock "rights" a shareholder who wishes to retain the same pro rata interest in the corporation must pay the subscription price for the new shares, which perchance he has been obliged to raise by a loan upon a pledge of his assets. In the case of *United States v. Phellis*, decided November 21, 1921, which related to the taxability as income of shares of stock in one corporation distributed by another corporation, this Court said:

"The liability of a stockholder to pay an individual income tax must be tested by the effect upon the transaction of the individual."

The *ratio decidendi* was the recognition by this Court that a dividend payable by one corporation in stock of another corporation was a severance of that stock from the assets of the first corporation and was a distribution of a portion of its assets. This thought is well brought out in the following quotation from this Court in that case:

"There was neither express nor implied condition, arising out of the plan of reorganization or otherwise, to prevent any stockholder from selling it [the stock in another corporation]; and he could sell his entire portion or any of it without parting with his capital

interest in the parent company, or affecting his proportionate relation to the interests of other stockholders. Whether he sold the new stock for money or retained it in preference, in either case when he received it he received as his separate property a part of the accumulated profits of the old company in which he had only a potential and contingent interest."

This is the difference between a true stock dividend and a dividend payable in the stock of another corporation. Can there be any doubt that the right offered by the corporation to subscribe its new stock at a price less than ~~a stock dividend~~ <sup>its actual</sup> is analogous to a stock dividend, and not to a distribution by one corporation of the shares of another corporation? See *Boardman v. Mansfield*, p. 9, *supra*.

To illustrate the principle is to solve the problem. Shares of stock having an actual value of \$50.00 each would on the issuance of an equal number of new shares at a subscription price of \$10.00 have then a value of only \$300.00. This is self-evident. The right to subscribe to a new share for \$100.00 is then obviously worth \$200.00. If the shareholder sell the right to subscribe for \$200.00 he has neither lost nor gained anything, and the \$200.00 is then *fixed* as a pro tanto return of his original investment. If the cost of the original investment happened to be less than \$200.00 there is concededly a taxable gain to the extent of the difference.

A manipulation of the stock would not affect the principle. A manipulation before the new issue would merely affect the value of the right, and the amount of the *pro tanto* return of the original investment, while a manipulation thereafter would

affect only the value of the shareholder's remaining interest, so far as he is concerned, and likewise would affect the value of the new shares in the hands of his vendee, but would have no greater effect upon the taxable income of either than the fluctuation in market value of any of their other assets. When the shareholder, or his vendee of the rights, thereafter sells the new shares, the government will collect its tax upon any gain there may be to the shareholder in excess of the value of the old shares less the proceeds from the sale of the rights, and to his vendee in excess of the sum paid for the rights plus the subscription price.

In this case the Hartford Fire Insurance Company doubled its capital stock by increasing the number of shares from 20,000 to 40,000, and pursued the customary practice of offering its new stock to its old shareholders at less than the market value thereof. Before the issue of new stock, the defendant in error owned an undivided 35 twenty-thousandths interest in the net assets of the Insurance Company worth, according to the Federal estate tax valuation, \$24,850. He could have maintained this proportionate interest only by subscribing to the offered 35 new shares at the subscription price of \$150 per share, when his interest in the corporation would have been 70 forty-thousandths and its value precisely the aggregate of \$24,850, the value of his original 35 shares, and \$5,250, his subscription to 35 new shares.

But the defendant in error, instead of taking up his subscription rights, sold them and therefore diminished his proportionate share in the corporation from 35 twenty-thousandths to 35 forty-thousandths. The proceeds of the sale of the rights were less than the cost of the original



shares. Looking at the substance and not the form, can it be said by any stretch of the imagination that he has had the benefit of gain, profit or income from the transaction? Rather has he received what is at most a partial reimbursement of the original investment. His voting power and his voice in the management of the corporation, his proportionate ownership of the assets, his proportionate interest in the earnings and his potential chances of a profit or loss on his original investment, have all been cut exactly in half, and he has undoubtedly diminished, by the amount of the proceeds of the sale of the rights, his investment in the Insurance Company. And whether this investment will finally be a profitable or unprofitable one will depend upon the future operations of the company and the consequent value of its stock. The corporation may do well, and as the proceeds of the sale of the rights are credited to the original cost price of his investment, he may, when he disposes of his original stock, have a gain. This would be taxable. The corporation may strike lean years, and his original investment, less the proceeds from the sale of the rights, be wiped out. He cannot know whether or not there is a gain or a loss until his investment is sold or liquidated.

The proceeds of the sale of stock rights in substance is nothing more nor less than a *pro tanto* liquidation of this asset of the shareholder. In this aspect it is not dissimilar from a liquidation dividend, and therefore certainly is not taxable. See *Lynch v. Turrish*, 247 U. S. 221.

## POINT IV.

**The taxability of the proceeds of the sale of rights is controlled by the decisions of the Supreme Court in the stock dividend cases of: *Towne v. Eisner*, and *Eisner v. Macomber*.**

The Government's contention that the full sum realized from the sale of the right should be taxable leaves out of consideration the loss in value of the old share, or the impairment of the capital of the taxpayer, and leaves out of consideration the fact that the corporation has disposed of nothing from its assets to the shareholder, and has distributed nothing. This is the *Macomber* case on all fours. To tax it now and say that this loss can be taken if and when the remainder of the capital itself—the old share—is sold, is to tax by the back door not income but capital, which cannot be taxed directly at the front door under the Sixteenth Amendment. If the Government recognizes that there is a *loss* of capital it cannot in the same breath argue for the taxation of a fictitious or supposititious gain. It must in fact be income. *Towne v. Eisner*, 245 U. S. 418. In that case the District Court, 242 Fed. 702, stated on page 704:

“It is manifest that the stock dividend in question cannot be reached by the Income Tax Act, and could not, even though Congress expressly declared it to be taxable as income, unless it is in fact income.”

And this language is adopted and approved in *Eisner v. Macomber*, *supra*. If the Congressional power to tax stock dividends is inhibited and clear-

ly limited (the Macomber case says so), unless in fact there be income, necessarily it follows that the same limitations are applicable to the sale of rights to subscribe to stock, unless in fact there be income. Capital itself cannot be taxed directly by Congress without an apportionment among the states. *Pollock v. Farmers' Loan & Trust Co.*, 158 U. S. 601. This is so well settled, it is basic.

The sole question involved in this case is whether the whole proceeds of sale of the rights to subscribe to stock are taxable as income. The issue is thus a narrow one, but a strikingly clear one, and does not comprehend a consideration of the elements, even if they were pertinent, involved in *Von Baumbach v. Sargeant Land Co.*, 242 U. S. 503; 37 Sup. Ct. 201; 61 L. Ed. 460, and *Stanton v. Baltic Mining Co.*, *supra*. But the *Von Baumbach* case had to do with the excise tax on the operation of corporations under the Corporation Tax Law of 1909 (36 Stat. at L. 11, 112 Chap. 6).

A mining corporation is in a sense a manufacturing plant. The naked tract of land, unworked, might be of no practical value. Theoretically the whole value of the mine existed, but labor in the acts of excavation, discovery, development, extraction of the ore, etc., renders it of value. Under the definition in the *Stratton's Independence* case, and the *Eisner v. Macomber* case, both *supra*, labor is one of the productive agencies of income.

## POINT V.

**Conclusion: Proceeds of sale not income hence not within purview of Sixteenth Amendment.**

In this case the alleged income is not a product of operation of any thing, it is a *gain* (if gain it be) produced by the sale or exchange of properties. If no gain has been realized on the original investment of the shareholder, who is the taxpayer, income is non-existent. No difficulty of accounting or of law is presented. The original cost of the original investment of the shareholder is known, and the value of the same on March 1st, 1913 (if made before) is known or ascertainable. This is the measuring point. A disposition of an inherent element of the original holding, which is at once reflected in the reduced value of the original holding, is not such a disposition of that holding as to be subject to a tax on "gains, profits and income." The gain or loss is not yet. It is inchoate. It is in the hopes of the taxpayer. It still lies on the laps of the gods.

When the original investment is sold, then the gain is, if gain there be, and then, and only then, does the tax attach. Up to this point nothing has been realized. The Sixteenth Amendment does not permit a tax on the hopes of men. It permits the tax only of the income, the gain, or the profits actualized.

It being true then that (1) Congress under the Sixteenth Amendment can tax only income, and (2) that income must be a gain or profit produced from labor, or capital, or both combined, or by a

sale or conversion of the property, and (3) that the gain or income must be realized, and (4) that stock dividends are not income until made so by a sale or conversion of the investment for a sum in excess of the original cost, we contend that it follows from the decisions and argument above set out, and particularly from *Towne v. Eisner*, and *Eisner v. Macomber*, as well as *Boardman v. Mansfield*, and similar cases, that the proceeds of the sale of rights to subscribe to an increased issue of capital stock of a corporation are not income, nor gain, nor profit, until and unless they are actually made so by a sale or conversion of the original holding, or the sale of the rights at a sum in excess of the original cost price of the original investment. If this reasoning is correct, the proceeds of sale of *any* portion of the "rights" are at least *in part* a return of capital and hence are not *wholly* income. In view of the narrow issue presented on this appeal, we are not here concerned with the correctness of the basis of calculation adopted by the lower court, and it follows that its opinion must be affirmed.

## POINT VI.

### **Trefry v. Putnam, 227 Mass. 522.**

There is only one case exactly in point, and that is *Trefry v. Putnam*, 227 Mass. 552, and this case if it does not indeed turn upon the peculiar construction of an amendment to the Constitution of Massachusetts, is clearly discredited by the decision in *Eisner v. Macomber*, *supra*, and is di-

rectly in conflict with the Macomber case as to the taxability of stock dividends.

The trial court in the case at bar in discussing the Putnam case said:

“If the stockholder must pay an income tax upon the full nominal amount of a stock dividend, he can hardly escape from paying upon all he gets from the sale of stock rights. It is impossible to be sure that the Supreme Judicial Court would have held the latter taxable, had it not first reached the conclusion that the former were.”

All the Courts that hold stock dividends capital, also hold stock rights capital; and those Courts that hold stock dividends income to the life tenant hold, nevertheless (with the exception of the Court in *Holbrook v. Holbrook*, 74 N. H. 201, *supra*) that stock rights are part of the principal. Clearly, then, the case at bar is controlled by *Towne v. Eisner*, *supra*, and *Eisner v. Macomber*, *supra*, the latter of which has drawn any poison that may have lurked in the fangs of *Trefry v. Putnam*, *supra*.

**We submit, therefore, that the decision of the District Court should be affirmed.**

Respectfully submitted,

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